9-1-1977

# Bankruptcy

Leonard H. Gilbert

Robert Pass

# BANKRUPTCY

LEONARD H. GILBERT* AND ROBERT PASS**

*The authors analyze developments in bankruptcy, including decisions involving the rights of secured parties and lienors, jurisdiction of the bankruptcy courts, valuation of security, discharge, preferences and newsman's and attorney-client privileges in bankruptcy. The article also reports recent decisions interpreting the Uniform Commercial Code as it pertains to bankruptcy. Included are a number of bankruptcy issues which recently have been adjudicated for the first time.*



---

* Partner in the firm of Carlton, Fields, Ward, Emmanuel, Smith & Cutler, P.A., Tampa, Florida.

** Associate in the firm of Carlton, Fields, Ward, Emmanuel, Smith & Cutler, P.A., Tampa, Florida.

## I. INTRODUCTION

There is no Florida law of bankruptcy. While there exist some state-provided avenues for the relief of distressed debtors, the term "bankruptcy" connotes the body of federal statutory and decisional law arising under the federal Bankruptcy Act.[1] The law surveyed in this article is therefore largely federal.

This article does focus, however, upon Florida-related decisions, i.e., the decisions of the federal bankruptcy judges and district courts sitting in Florida, as well as the United States Court of Appeals for the Fifth Circuit. There are three reasons for this emphasis. First, the Bankruptcy Act frequently looks to state law to supply the rule of decision. In most cases, only the bankruptcy courts sitting in Florida would apply Florida law. Second, Florida creditors, Florida debtors, and Florida lawyers are assumed to be among those most interested in what the bankruptcy courts in Florida are doing. Last, Florida is a very populous state, and the bankruptcy courts sitting in it are among the busiest in the nation. It therefore seems reasonable to proceed on the assumption that the decisions of these courts are representative of the general development and trend of bankruptcy law.

## II. SECURED PARTIES AND LIENORS

### A. *Holders of Security Interests*

#### 1. FUTURE ADVANCES

In *In re Howdeshell Plumbing, Inc.*[2] the court went behind the clear "cross collateralization" or "future advances" language in two security agreements to hold that subsequent debts incurred by the debtor were not secured by the agreements.[3] The security agreements were executed in connection with the debtor's purchase of two vehicles. The debtor subsequently obtained a loan from the

1. 11 U.S.C. §§ 1-1103 (1970). The Bankruptcy Act is referred to in this article as the "Act." All citations herein are to the Act. A cross reference table to the U.S.C.A. appears at 11 U.S.C.A. XIV (1973).

2. No. 75-729 (M.D. Fla. Aug. 9, 1976).

3. The security agreement, executed on standard UCC form 210, stated that it secured " 'any and all other liabilities or obligations . . . due or to become due . . . of each borrower . . . to the Secured Party.' " *Id.* at 2. A second security agreement which used similar language was executed on another item of collateral.

same creditor. The debtor executed a promissory note, which provided for a description of collateral. The term "open" was typed into the collateral description blank. No security agreement was executed in connection with the latter loan.

Although the cross collateralization language of the original two security agreements was unambiguous, the court found that the series of transactions created enough ambiguity to require an examination of the intent of the parties. The court then concluded that it was the intention of the parties to treat the subsequent loan as unsecured, thereby negating the clear, literal import of the earlier collateralization clauses. Relevant considerations were that the creditor had carried the subsquent loan on its books as unsecured, and that an executive vice president of the creditor had suggested that the note should be renewed only on a secured basis.

Future advances clauses cause existing, identified collateral to secure present and subsequent indebtednesses of the borrower. They are "boilerplate" terms and are clearly enforceable.[4] However, the *Howdeshell* court did not follow the literal meaning of the "boilerplate" terms. Although it has been said that the intent of the parties in making future advances has no bearing upon whether such advances are subject to a prior future advances agreement,[5] it seems more reasonable, as the *Howdeshell* decision recognizes, to effectuate the intent of the parties. One way this policy traditionally has been accomplished is to recognize that, absent a clear expression of intent to the contrary, only a future indebtedness of the same type as that which gave rise to the original agreement should be presumed to be covered by the future advances clause.[6]

4. State Bank v. United States (*In re* Riss Tanning Corp.), 468 F.2d 1211 (2d Cir. 1972); Mason v. Avdoyan, 299 So. 2d 603 (Fla. 4th Dist. 1974).

5. Barksdale v. Peoples Financial Corp., 393 F. Supp. 112 (N.D. Ga. 1975).

6. Kimbell Foods, Inc. v. Republic Nat'l Bank, 401 F. Supp. 316 (N.D. Tex. 1975). In *Kimbell Foods*, the court observed that:

> Section 9-204(e) of the Uniform Commercial Code . . . allows the creation of clauses in an original security agreement that would secure future advances made to the original debtor. However, *these clauses will be closely scrutinized and will be enforced only to the extent that future transactions or liabilities sought to be secured were in the clear contemplation of the parties.* The reason for this rule is that this device can be abused when the lender seeks to bring in claims against the debtor that were not originally contemplated by the parties. . . . *The future advances must be of the same class as the primary obligation and be so related that the consent of the debtor may be inferred.*
>
> The true intention of the parties is really the sole and controlling factor in

This approach could have been the basis for the *Howdeshell* decision. The court observed that it was satisfied that the parties intended to deal on a "single loan" basis in financing the original transactions. Yet, the *Howdeshell* court strove to refute the clear language of the security agreements through subsequent conduct. The decision therefore justifies increased care by the practitioner. It militates strongly in favor of *expressly* identifying all subsequent loans as secured by prior collateral when each new loan or advance is made, particularly when the loan is of a different class or type than those for which an earlier future advances clause was executed. A sufficient notation of intent could be made in the documents accompanying the subsequent advances; a new security agreement should be unnecessary.

### 2. ASSIGNMENT OF SECURITY INTEREST

In *Ritter v. Hughes*,[7] an arrangement proceeding, the debtor purchased $300,000.00 worth of plants from the seller. The debtor agreed to deliver a promissory note to the seller for the purchase price. The note was to be endorsed with recourse by the seller to a bank. A security interest in the plants was granted to secure the purchase price. The security agreement provided that the security interest in the plants would " 'also . . . secure any other indebtedness of Buyer (debtor) to Seller.' "[8] When the note was endorsed to the bank, the security agreement between the debtor and the seller purportedly was given to the bank was collateral. The assignment stated that it gave the bank all of the seller's right, title, and interest in the security agreement.

Except for the purchase price of the plants, the debtor was not indebted to the seller at the time the security agreement was executed. After the assignment to the bank, the seller sold more plants to the debtor for over $55,000.00 and he was not paid.

---

> determining what future advances were covered by the original agreement. If the parties intended to deal on a single loan basis . . . then each new agreement would have to be reperfected.

*Id.* at 325 (emphasis added). *Accord, In re* Dorsey Elec. Supply Co., 344 F. Supp. 1171 (E.D. Ark. 1972) (intention to cover future advances which are not of the same class must be clearly set forth in security agreement); John Miller Supply Co. v. Western State Bank, 55 Wis. 2d 385, 199 N.W.2d 161 (1972).

7. No. 75-1172 (S.D. Fla. Sept. 27, 1976).

8. *Id.* at 1.

The question presented in the proceeding was whether the seller, when he created the $55,000.00 debt on the subsequent sale, retained a security interest in the original plants which he had sold to the debtor. The debtor contended that the seller did not retain such an interest for three reasons: (1) The filed Uniform Commercial Code (UCC) form reflecting the assignment of the seller's security interest contained no statement that any security interest was retained by him; (2) the original agreement did not grant a security interest to the seller for future advances; and (3) the assignment transferred all rights of the seller to claim the security interest for an indebtedness arising after the assignment.

The court rejected all three contentions. With regard to the first contention, the court noted that filing a notice of assignment under section 9-405 of the UCC[9] serves only as a notice to the public that a security interest might be claimed by a third party, not as a relinquishment of the assignor's security interest. Relying upon the only reported decision on the question, *Mills Morris Co. v. Scanlon (In re King-Porter Co.)*,[10] the court held that the filing of the assignment under section 9-405 did not operate to assign the security interest over the contrary intention of the parties.

Concerning the contention that the original security agreement granted no security interest for future advances, the court held that the reference in the original agreement to "any other indebtedness" had the same meaning as "any future indebtedness" in view of the surrounding circumstances. When the original agreement was executed, there was no other indebtedness between the debtor and the seller. The only other indebtedness between the parties would have

9. Florida Statutes section 679.405 (1975), which is not identical with the 1962 revised Uniform Commercial Code text, provides in pertinent part that:

> (1) A financing statement may disclose an assignment of a security interest in the collateral described in the statement . . . .
>
> (2) A secured party may assign of record all or part of his rights under a financing statement by the filing of a separate written statement of assignment . . . .
>
> (3) After the disclosure or filing of an assignment under this section, the assignee is the secured party *of record.*

(Emphasis added).

10. 446 F.2d 722 (5th Cir. 1971). The court in *Mills* observed that: "[U]pon filing a notice of assignment of a security interest under the Code, the designated assignee becomes the secured party *of record.* . . . This procedure cannot, nor was it intended to, work a substantive assignment where none was intended by the parties." *Id.* at 728 (emphasis in the original).

to arise from a future advance.

Finally, the court rejected the contention that the assignment to the bank transferred the seller's right to hold a security interest on any future indebtedness. The court found that the assignment was "conditional"; if the bank were not paid by the debtor, and the seller then were required to pay any portion of that obligation, the security agreement would revert to the seller. As a result, there was no final and irrevocable transfer of the seller's security interest in future advances made by him to the debtor.

The rationale employed by the court in holding that no assignment occurred requires some scrutiny. Section 9-405(1) of the UCC provides that "an assignment of a security interest" may be "disclose[d]" in a financing statement. Section 9-405(3), upon which the *Ritter* and *Mills* decisions relied, states that "after the disclosure or filing of an assignment under this section, the assignee is the secured party *of record*."[11] It seems clear that the UCC provisions contemplate that an actual or substantive assignment occur before filing a separate financing statement giving record notice of the assignment. The official comment to section 9-405 states that the

> section provides a *permissive* device whereby a secured party *who has assigned* all or part of his interest may have the assignment noted of record. . . . *After* a secured party *has assigned* his rights of record, the assignee becomes the 'secured party of record' and may file a continuation statement . . . a termination statement . . . or a statement of release . . . .[12]

Once the transfer provisions of section 9-405 are satisfied, the assignee, now the secured party of record, apparently can extinguish the perfected nature of the assignor's interest (assuming one was retained) by filing a termination statement,[13] or by a release of the collateral.[14]

The *Ritter* and *Mills* decisions indicate that section 9-405 provides only a permissive device allowing the putative assignee to release collateral or to terminate the recorded security interest. However, a section 9-405 filing may have an important effect on the

---

11. U.C.C. § 9-405(3) (emphasis added).
12. U.C.C. § 9-405, Comment (emphasis added).
13. FLA. STAT. § 679.404 (1975).
14. FLA. STAT. § 679.406 (1975).

assignee. Although under section 9-302(2) an assignee need not file a notice of assignment to maintain the perfected nature of his security interest against the debtor's creditors, he must file a notice of assignment in order to maintain that perfection against creditors of the *assignor*.[15] It is therefore strongly in the interest of only a true assignee to file under section 9-405. If there were no real assignment of the security interest, perfection would continue in the original secured party, and the assignee, when he truly became an assignee, would be protected at the time of assignment against all otherwise junior creditors.[16]

The court in *Mills* noted that an erroneously filed notice of assignment would not mislead creditors, since it indicates only that the secured party of record *may* hold an interest in certain collateral. Further inquiry by creditors is anticipated "to disclose the complete state of affairs."[17] However, there is no good reason to file under section 9-405 when there has been no substantive assignment of the security interest. Even the *Mills* court recognized that it was erroneous to do so.[18] In addition, because of the potential for confusion and the desirability of avoiding unnecessary filings, the courts should not be so willing to find no assignment in fact when there has been one of record.

### 3. RECLAMATION RIGHTS OF SELLER

In *Kennedy v. Texas Meat Packers Corp.*,[19] the court rejected a seller's attempt to reclaim goods under UCC section 2-702, despite the seller's claim that he made a timely demand that proved futile. The court held that the bankruptcy trustee had a superior claim to the goods. The plaintiff sold and delivered meat to a buyer when the buyer was insolvent. Within ten days of delivery of the merchandise, the seller visited the offices of the bankrupt in an attempt to recover the merchandise or collect the purchase price. The premises were vacant. The seller did nothing more within the ten day period to reclaim the goods.

15. FLA. STAT. § 679.302 (1975).
16. *See* Epstein, *Security Transfers By Secured Parties*, 4 GA. L. REV. 527, 528-29 (1970).
17. Mills Morris Co. v. Scanlon (*In re* King-Porter Co.), 446 F.2d at 729; *accord*, U.C.C. § 9-402, Comment 2.
18. 446 F.2d at 729.
19. No. 76-858 (S.D. Fla. Nov. 18, 1976).

The purchaser later filed in bankruptcy, and the seller again attempted to reclaim the merchandise under UCC section 2-702.[20] It was conceded that the seller did not make a personal demand upon the buyer within ten days of the buyer's receipt of the merchandise as required by section 2-702. The seller argued that he was excused from strict compliance with the UCC, because he went to the bankrupt's premises within ten days, but could not make a demand since the premises were vacant. The court disagreed, pointing out that the seller retained ownership of the goods until final payment was made, and that he could have perfected his interest by filing a financing statement within the ten day period. The court indicated strongly that it viewed the ten day rule contained in section 2-702 as absolute.

In so ruling, the court relied upon *Stowers v. Mahon (In re Samuels & Co.)*.[21] In *Stowers*, the Fifth Circuit held originally that strict compliance with the ten day limitation period of section 2-702 was unwarranted because the goods to be reclaimed (cattle) were immediately butchered and placed with other fungible, butchered carcasses, making futile a demand for their return.[22] On rehearing en banc, the Fifth Circuit reversed its decision and adopted the dissenting opinion of Judge Godbold. Judge Godbold argued that compliance with the Code's ten day provision is an absolute requirement: "There is no exception in the Code Sections or Comments, express or implied, to the statutory period. . . . The spirit in which the rule was broken seems to me irrelevant."[23]

The *Stowers* and *Texas Meat Packers* decisions evidence an increasingly severe judicial view of the seller's reclamation rights under section 2-702. The *Stowers* case appeared to make the ten day provision of the section a simple, absolute requirement. The court in *Texas Meat Packers* furthered the strict compliance approach by requiring the seller to perfect promptly a security interest through the Code's filing provision if actual demand could not be made. The

20. FLA. STAT. § 672.702 (1975). This section provides in pertinent part:

> (2) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand within 10 days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within 3 months before delivery the 10 day limitation does not apply.

21. 526 F.2d 1238 (5th Cir. 1976), *rev'g en banc* 510 F.2d 139 (5th Cir. 1975).

22. 510 F.2d at 148.

23. 526 F.2d at 1245.

court observed that "[i]f, in each case of no demand, the Court would have to make a determination as to the ten day rule being applicable, that time limit would soon have no effect."[24]

The admonition has become reinforced; actual demand for return must be made within ten days of delivery to an insolvent buyer or the seller's interest must be perfected by filing. Even diligent search and inquiry, where fruitless, will not suffice. It should also be noted that even if demand is timely, one may severely prejudice or waive his reclamation right by failing to "follow up" the demand by a bona fide attempt to reclaim the merchandise.[25]

Regardless of compliance by a seller with section 2-702, unresolved questions remain. Section 67(c)(1)(A) of the Act[26] invalidates all statutory liens "which first becomes effective upon the insolvency of the debtor . . . ." It has been held that section 67(c)(1)(A) invalidates rights acquired under the reclamation provisions of the UCC as against the trustee.[27] Since UCC section 2-702 takes effect only if the buyer is insolvent, it has been held that section 2-702 has no application in bankruptcy against the trustee.[28] However, the matter has been the subject of considerable disagreement.

In addition, section 70c of the Act gives a trustee the same powers and status as a hypothetical lien creditor under state law at the time of filing under the Act. Under a literal reading of Florida Statutes section 672.702(3) (1975), the unpaid seller loses to the trustee, who assumes the position of a lien creditor.[29] In order to avoid such a result, some states have dropped the "lien creditor" language of UCC section 2-702(3).[30] Most states, including Florida,

24. No. 76-858, slip op. at 4 (S.D. Fla. Nov. 18, 1976).

25. Bar Control v. Grifford (*In re* Colacci's of America, Inc.), 490 F.2d 1118 (10th Cir. 1974).

26. Section 67(c)(1)(A) provides: "The following liens shall be invalid against the trustee: (A) every statutory lien which first becomes effective upon the insolvency of the debtor . . . ."

27. Carnation Plastic Mfg. Co. v. Giltex, Inc., 17 U.C.C. Rep. 887 (S.D.N.Y. 1975).

28. *In re* Good Deal Supermarkets, Inc., 384 F. Supp. 887 (D.N.J. 1974); *In re* Federal's, Inc., 12 U.C.C. Rep. 1142 (E.D. Mich. 1973). *See* 4 COLLIER ON BANKRUPTCY ¶ 67.281, at 420-21 (14th ed. Moore & Oglebay 1975); J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE, § 7-15, at 241-45 (1972).

29. *Contra, In re* Royalty Homes, Inc., 8 U.C.C. Rep. 61 (E.D. Tenn. 1970).

30. WHITE & SUMMERS, *supra* note 28, at 244 n.101. These changes were in reaction to *In re Kravitz*, 278 F.2d 820 (3d Cir. 1960), which held that since the UCC does not spell out the priority between an unpaid seller and another lien creditor, resort to the forum's common law was necessary. The forum law in *Kravitz* made the lienor the party of higher priority.

have not dropped this language; nor has the Permanent Editorial Board for the UCC done so. It is contemplated that, under general principles of law, the unpaid seller would prevail over the lien creditor. The Code says only that the unpaid seller's right to reclamation is "subject to" the rights of a lien creditor.[31] The Code does not define the rights of a lien creditor. In any event, the reclaiming seller's interest is not a preference under section 60a of the Act.[32]

#### 4. SECURITY AGREEMENTS BY INFERENCE

In *In re Babb, Inc.*,[33] an arrangement proceeding, the court authorized a creditor to repossess substantial assets of the debtor. Although a formal security agreement was never executed, the court found the creditor to be secured. In so doing, the court effectuated the language in a financing statement evidencing an *intent* to secure the creditor by the debtor's assets. The holding affirmed the principle which was employed recently in *Morey Machine Co. v. Great Western Industrial Machine Co.*[34] The court in *Morey* noted that the UCC does not "require . . . that the financing statement be a separate piece of paper from the security agreement, or that any particular words be used to evidence the security interest."[35] In *Morey*, the court held that the simple observation in a financing statement that documentary stamps had been placed on the promissory instruments "secured hereby" was sufficient to create a security agreement.[36]

In normal commercial practice a security agreement is a document separate from a financing statement. It has been held, however, that a financing statement *may* serve as a security agreement, if the statutory requirements of UCC sections 9-105(1)(h) and 9-203(1)(b) are satisfied.[37] Thus, in *Nolden v. Plant Reclamation (In*

31. U.C.C. § 2-702(3).

32. *See* 3 COLLIER ON BANKRUPTCY, *supra* note 28, ¶ 60.18.

33. No. 75-112 (M.D. Fla. Nov. 18, 1976).

34. 507 F.2d 987 (5th Cir. 1975).

35. *Id.* at 988. Florida Statutes section 679.203 (1975) provides in pertinent part that: "A security interest is not enforceable against the debtor or third parties unless . . . . [t]he debtor has signed a security agreement which contains a description of the collateral . . . ." Florida Statutes section 679.105 (1975) defines a "security agreement" as "an agreement which creates or provides for a security interest."

36. 507 F.2d at 890.

37. Nolden v. Plant Reclamation (*In re* Amex-Protein Dev. Corp.), 504 F.2d 1056 (9th Cir. 1974); Evans v. Everett, 183 S.E.2d 109 (N.C. 1971).

*re Amex-Protein Development Corp.)*,[38] the court held that a promissory note which contained an acknowledgement that it was secured by a security interest in certain property was sufficient to establish a security interest in that property.[39] A security agreement also has been found where a letter accompanying a promissory note stated that "the above arrangements are in accordance with our loan agreement" and the oral loan agreement was proved to contain the grant of a security interest.[40]

Such decisions represent the salvation of a careless creditor, particularly in bankruptcy, where the difference between a secured and unsecured creditor could not be greater. However, the informed creditor will execute a formal security agreement at the outset, thus eliminating the necessity of reliance upon marginal or offhand references or notations to "security." Absent a recognizable security agreement, the security interest and its scope must be proved by the party seeking to enforce it.

### 5. NON-CODE SECURITY INTERESTS

A rarely litigated question was presented in *Hughes v. Russo (In re Equitable Development Corp.)*.[41] A bankrupt corporation borrowed money from Russo. The loan was evidenced by a note which was secured by a mortgage on realty, by a security pledge agreement, and by an assignment of accounts receivable. The pledge agreement and assignment of accounts receivable gave the lender the right to obtain proceeds from contracts for the sale of land. No financing statement was filed by Russo at the time, and none was filed until after the petition in bankruptcy.

The trustee sought to invalidate as preferences Russo's claimed interests in the proceeds of the land sales contracts. The trustee argued that since no financing statement was filed by Russo before the filing of the petition in bankruptcy, under section 60a(2) of the Act the security interest was "transferred" immediately prior to the petition, thereby making the "transfer" a voidable preference. Section 60a(2) provides that, for preference purposes, "a transfer of

38. 504 F.2d 1056 (9th Cir. 1974).

39. *Accord, In re* Numeric Corp., 485 F.2d 1328 (1st Cir. 1973).

40. Nunnemaker Transp. Co. v. United Cal. Bank, 456 F.2d 28 (9th Cir. 1972). *See In re* Penn Housing Corp., 367 F. Supp. 661 (W.D. Pa. 1973); *In re* Carmichael Enterprises, Inc., 334 F. Supp. 94 (N.D. Ga. 1971), *aff'd per curiam*, 460 F.2d 1405 (5th Cir. 1972).

41. No. 75-751 (S.D. Fla. Dec. 13, 1976).

property other than real property . . . shall be deemed to have been made . . . when it becomes so far perfected that no subsequent lien . . . obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee."[42] The section further provides that if any transfer of personalty is not so perfected prior to the filing of a petition in bankruptcy, it "shall be deemed to have been made immediately before the filing of the petition" and thus would be voidable under the four month preference rule. Russo contended that the security and pledge agreement and the assignment of accounts receivable gave him an "interest in land" which was not governed by the UCC. He claimed he had become secured at the time of the original transaction, which was prior to the start of the Act's preference period. The trustee argued that Russo obtained only an interest in personalty which was not "perfected" except by operation of the automatic "transfer" provisions of section 60a(2).

So framed, the issue was whether a security interest in contracts for the sale of land was subject to the filing requirements of Article 9 of the UCC. The court held that such an interest was within Article 9 and subject to UCC filing requirements, thereby allowing the trustee to prove a preference.

Florida Statutes section 679.104(10) (1975), excludes from Article 9 "an interest in or lien on real estate, including a lease or rents thereunder."[43] Official comment 2 to UCC section 9-104(j), the counterpart to section 679.104(10), makes clear that Article 9 "applies only to security interests in personal property."[44] Section 679.102(1)(a) expressly provides that Article 9 governs security interests in "personal property . . . accounts or contract rights."[45] Section 679.102(3) states that the application of Article 9 to "a security interest in a secured obligation is not affected by the fact that the obligation is itself secured by [an] . . . interest" to which the Article does not apply.[46]

These provisions, as well as the decision in *Riebe v. Budget Finance Corp.*,[47] were relied upon by the *Russo* court in its decision

42. Bankruptcy Act § 60(a)(2).

43. FLA. STAT. § 679.104(10) (1975).

44. U.C.C. § 9-104(j), Comment 2. Special provision is made, however, for security interests in fixtures. FLA. STAT. §§ 679.104(10), 679.313 (1975).

45. FLA. STAT. § 679.102(1)(a) (1975).

46. FLA. STAT. § 679.102(3) (1975).

47. 264 Cal. App. 2d 576, 70 Cal. Rptr. 654 (Ct. App. 1968).

that the security and pledge agreement and the assignment of accounts receivable represented nothing more than security interests in personalty — contract rights — which were within Article 9. The fact that the contracts from which the security interest arose were for the sale of land was held irrelevant. *Russo* is in accord with official comment 4 to section 9-102(3) of the Code:

> The owner of Blackacre borrows $10,000 from his neighbor, and secures his note by a mortgage on Blackacre. This Article is not applicable to the creation of the real estate mortgage. Nor is it applicable to a sale of the note by the mortgagee, even though the mortgage continues to secure the note. *However, when the mortgagee pledges the note to secure his own obligation to X, this Article applies to the security interest in an instrument even though the instrument is secured by a real estate mortgage* . . . .[48]

Thus, all creditors except those whose notes are secured by true mortgages on real estate should take all steps necessary under the Code to perfect their security interests. Even notes secured by deeds of trust on real property may be within Article 9.[49] Cases in other jurisdictions, seemingly in conflict with *Russo*, have held that notes secured by leases of real property are *outside* Article 9, even though the immediate security for the note is essentially a contract.[50]

### 6. VOLUNTARY PARTICIPATION BY SECURED CREDITORS

It has been stated that the central purpose of an arrangement under chapter XI of the Act is to "secure judicial confirmation to an arrangement, or adjustment, of a debtor's unsecured obligations."[51] Section 356 of the Act, governing the contents of an arrangement, requires a plan to include provisions modifying or altering only the rights of unsecured creditors. The rights of secured creditors are not part of the plan. It has been said that "[n]o

48. U.C.C. § 9-102(3), Comment 4 (emphasis added).

49. *Cf. Id.*.

50. *In re* Bristol Ass'n, 505 F.2d 1056 (3d Cir. 1974) (lease of store); Ingram v. Ingram, 521 P.2d 254 (Kan. 1974) (oil and gas lease is realty under state law). However, an interest in a land trust, generally held to be personalty under state law, has been held to be within Article 9. Levine v. Pascal, 236 N.E.2d 425 (Ill. App. 1968).

51. RIDC Indus. Dev. Fund v. Snyder, 539 F.2d 487, 492 (5th Cir. 1976) (emphasis added), *citing* SEC v. American Trailer Rentals, 379 U.S. 594, 605 (1965) and SEC v. U.S. Realty & Improvement Co., 310 U.S. 434, 445 (1940).

provision of the Act permits the plan proposed under Chapter XI to deal with the rights of secured creditors."[52]

A secured creditor has a number of options which are unavailable to the unsecured creditor. He may disregard the arrangement proceeding altogether, file no claim, and rely upon his security if it is in his possession.[53] He may file a secured claim against the estate if the security for the debt owed to him is within the jurisdiction of the court.[54] He may surrender or waive his security and prove his claim as an unsecured claim, or he may avail himself of his security and share in the general assets as to the unsecured balance.[55] Generally, the secured creditor enjoys the option of staying out of the arrangement or getting involved in varying degrees. He cannot be forced to participate.

Section 16 of the Act provides that the liabilities of the bankrupt's guarantors or sureties are not altered by the bankrupt's discharge. This section makes clear that a discharge affects only the personal liability of the debtor, not those against whom his creditors were entitled originally to look for payment of the discharged debt.[56]

These established principles recently came together in *RIDC Industrial Development Fund v. Snyder*.[57] RIDC, a secured creditor, sued the guarantor of a debt which was discharged as to the debtor through an arrangement. Two credit transactions were executed originally between RIDC and the debtor. Both were secured by property of the debtor. The guarantor executed guaranties for both. Subsequently, the debtor was acquired by another corporation. In connection with the acquisition, a new agreement which modified the original security agreement was executed. The modification was accomplished with the consent of the guarantor.

In the debtor's subsequent arrangement proceeding, RIDC was involved voluntarily as a participant in the plan. The guarantor was not consulted. The plan provided in part that any indebtedness owed to secured creditors who executed a consent to the plan were

52. 9 Collier on Bankruptcy, *supra* note 28, ¶ 8.01[3], at 168, *quoted in In re* Texas Consumer Fin. Corp., 480 F.2d 1261, 1265 (5th Cir. 1973).

53. United States Nat'l Bank v. Chase Nat'l Bank, 331 U.S. 28, 33-34 (1947); In re Pennyrich Int'l Inc., 473 F.2d 417, 421 (5th Cir. 1973).

54. 331 U.S. at 33-34; 473 F.2d at 421.

55. 331 U.S. at 33-34; 473 F.2d at 421.

56. *See* Merrit-Holland Welding Supplies, Inc. v. General Steel Tank Co., 478 F.2d 294 (4th Cir. 1973); 1A Collier on Bankruptcy, *supra* note 28, ¶ 16.

57. 539 F.2d 487 (5th Cir. 1976).

to be cancelled, discharged, and extinguished and that the arrangement, when confirmed, would supersede the security agreement.

After discharge of the debtor, RIDC sued the guarantor. The guarantor argued that he was discharged from his guaranty because RIDC's participation in the plan cancelled and extinguished the principal debt without his consent. RIDC argued that section 16 of the Act reserved its rights against the guarantor. The guarantor's answer was that because RIDC participated in the plan as a secured creditor and chapter XI has been held not to deal with secured creditors, RIDC's legal rights were not protected by section 16. He argued further that since the debt owed to RIDC was not discharged under the *coercive* effect of the bankruptcy court, the discharge of the principal obligation was purely voluntary. This fact, the guarantor argued, operated to discharge him under general principles of guaranty.

The district court agreed. It held that since RIDC, a secured creditor, participated in the plan without relinquishing its security, "the plan of arrangement could not affect the legal rights of the plaintiff in the manner provided for [in section 16]."[58] The court relied upon the decision of the Fifth Circuit in *In re Texas Consumer Finance Corp.*,[59] where the court observed: "No provision of the Act permits an arrangement proposed under Chapter XI to deal with the rights of secured creditors . . . . [O]nly the rights of the debtor's unsecured creditors may be arranged under Chapter XI." The district court concluded that RIDC was a "secured creditor" even though the debtor had conveyed the collateral to the acquiring corporation.[60] Having concluded that RIDC was a secured creditor and that the plan of arrangement could not therefore coercively affect

58. 387 F. Supp. 466, 470 (M.D. Fla. 1975).

59. 480 F.2d 1261, 1265 (5th Cir. 1973) (citations omitted).

60. This conclusion was not based upon the definition of a "secured creditor" under section 1(28) of the Act, but upon section 9-105(1)(i) of the UCC. The Code section defines a "secured party" as a "lender . . . in whose favor there is a security interest." Comment 2 to section 9-105(1)(i) observes that property is sometimes transferred subject to a secured debt, but that such a transfer does not necessarily render the original secured party unsecured. On the other hand, section 1(28) of the Act states that a "secured creditor" is a creditor who has security for his debt "upon the property of the bankrupt." This implies that once the collateral leaves the ownership of the bankrupt, as in the instant case, the creditor is no longer secured. Even though the district court applied an erroneous standard in determining secured creditor status, the Fifth Circuit found that sufficient collateral had been retained by the debtor to satisfy section 1(28), and agreed that RIDC was a secured creditor under the proper standards.

RIDC's rights, the district court further concluded under the common law of guaranty that the guarantor was released by the arrangement because it materially altered the principal obligation.

The Fifth Circuit reversed and expressly limited the broad statement made in *Texas Consumer Finance* concerning the effect of a plan upon secured creditors. The court pointed out that *Texas Consumer Finance* did not involve a secured creditor who voluntarily participated in the plan, but rather an attempt by the bankruptcy court to impose upon preferred shareholders a requirement that they surrender their shares prior to confirmation of the plan. In limiting the effect of *Texas Consumer Finance*, the Fifth Circuit recognized that chapter XI arrangements *may* deal with the rights of secured creditors to the extent that they deal with the claims of secured creditors for the excess due to them over the value of their security. More importantly, the court concluded that a bankruptcy court has both jurisdiction to impose restrictions on secured creditors prior to confirmation and authority to deal with the rights of secured creditors to the extent that they voluntarily agree to the arrangement.

In other words, the court in *RIDC* gave effect to the policy of encouraging secured creditors not to seek foreclosure of their security, but to participate in an arrangement under which they would receive compensation equal to their security interests.[61] Since RIDC participated in the arrangement not just to the extent it was unsecured, but completely, the court held that even though the bankruptcy court was without jurisdiction to compel a secured creditor to participate in an arrangement altering his security interests, the secured creditor was totally free to do so and could do so without sacrificing his section 16 rights. As a result, the court held that the bankruptcy court had jurisdiction to alter RIDC's secured creditor status, with RIDC's consent, and that it did so without prejudicing RIDC's other statutory rights. Thus RIDC was allowed to pursue the guarantor under section 16.

The decision in *RIDC* sends to an early grave the unfortunately broad language in *Texas Consumer Finance*. The decision serves an important policy of encouraging, but not compelling secured creditors to participate in the plan of arrangement, in order to maintain the going concern value of the debtor, rather than to seek foreclosure

61. 539 F.2d at 493.

of the debtor's assets. Although there may be circumstances in which the secured creditor is compelled by business reasons to participate in the plan anyway, the decision correctly saves to the secured creditor his rights to proceed against the debtor's guarantors, comakers, and sureties, notwithstanding his participation in the plan. Since the Act reserves for the unsecured creditor (who is effectively compelled to participate in the plan) the saving effect of section 16, it would make little sense to penalize the secured creditor who voluntarily participates in a plan by depriving him of the effect of section 16.

The *RIDC* decision does not address the case of the secured creditor who chooses to participate in the plan by waiving his security and proceeding as an unsecured creditor. Although such participation by the creditor would necessarily extinguish his status as a secured creditor and therefore his right to proceed against collateral, section 16 should still apply. Any other result would be contrary to the established meaning of section 16,[62] and to the policy just noted.

### B. *Lessor's and Landlord's Liens*

#### 1. PRIORITY OF LANDLORD'S LIEN

In *Avdoyan v. Small Business Administration (In re Brunet)*,[63] the court for the first time held that the "relating back" effect of the Florida Landlord Lien Law was ineffective to give the landlord priority over a lien that vested in fact after the time the landlord's lien vested under state law. The trustee had preserved the landlord's lien for the estate under the appropriate provisions of the Act.[64] The Small Business Administration (SBA) obtained a security interest in the debtor's property by assignment after the commencement of tenancy under the lease, but prior to any default. The trustee invoked the Florida Landlord Lien Law, which ficticiously relates back the landlord's lien for rent upon the lessee's property to the first time the property was first brought onto the leased premises.[65]

62. *See* 1A COLLIER ON BANKRUPTCY, *supra* note 28, ¶ 16.05.

63. No. 75-288 (M.D. Fla. Aug. 18, 1976).

64. Section 67c(1)(C) of the Act provides that statutory liens for rent and liens for distress of rent, whether statutory or not, are invalid against the trustee. However, section 67c(2) empowers the court to preserve any of the liens which are rendered invalid against the trustee.

65. FLA. STAT. § 83.08(2) (1975). This section provides:

The court held that the "relating back" effect of the Florida law was inconsistent with the federal common law notion of choate liens, and was therefore ineffective to give the landlord a lien prior to the time it became choate. Under federal law, an inchoate lien is a lien in which the certainty of amount, exact identity of the lienor, and time of attachment must await future determination.[66] The court thus held that the SBA lien was superior to the landlord's lien held by the trustee. The fact that the SBA did not acquire the lien until after the debtor was adjudicated bankrupt was unimportant since the SBA lien was choate in the hands of its assignor prior to the vesting of the landlord's lien.

*Avdoyan* does not eliminate the "relating back" effect of the landlord's lien for all purposes in bankruptcy. The federal test of choateness is applied when at least one lien at issue is that of a federal governmental entity.[67] Federal law determines priority of a federal government lien, whatever its source.[68] However, when no federal interests are at stake, the validity, nature, and effect of a state lien is still governed by state law.[69]

### 2. TERMINATION RIGHTS OF LESSOR

Section 70b of the Act recognizes expressly the enforceability of lease forfeiture provisions which terminate a lease upon bankruptcy.[70] Despite this seemingly unequivocal language, the United States Supreme Court has made it clear that, at least in reorganiza-

---

> Landlord's Lien for Rent. - Every person to whom rent may be due . . . shall have a lien for such rent upon the property found upon or off the premises leased or rented, and in the possession of any person, as follows:
>
> . . . .
>
> (2) Upon all [non-agricultural] property of the lessee or his sublessee or assigns, usually kept on the premises. This lien shall be superior to any lien acquired subsequent to the bringing of the property on the premises leased.

*See also*, Lovett v. Lee, 193 So. 538 (Fla. 1940); GMAC Corp. v. Noni, Inc., 227 So. 2d 891 (Fla. 3d Dist. 1969); McKesson & Robbins, Inc. v. Taft St. Shopping Center, 184 So. 2d 210 (Fla. 2d Dist. 1966).

66. United States v. New Britain, 347 U.S. 81, 84 (1954); United States v. White, 325 F. Supp. 1133, 1135 (S.D.W. Va. 1971); Stein v. Moot, 297 F. Supp. 708, 711 (D. Del. 1969).

67. United States v. Oswald & Hess Co., 345 F.2d 886 (3d Cir. 1965).

68. United States v. Securities Trust & Sav. Bank, 340 U.S. 47 (1950); United States v. Oswald & Hess Co., 345 F.2d 886 (3d Cir. 1965).

69. Porter v. Searle, 228 F.2d 748, 750 (10th Cir. 1955).

70. Section 70b provides in pertinent part: "An express covenant that . . . the bankruptcy of a specified party . . . shall terminate the lease or give the other party an election to terminate the same is enforceable."

tion proceedings, the statute does not dispense with the common law's disfavor of forfeitures. The Court has directed that the enforceability of such provisions be weighed against the public interest in obtaining a successful reorganization.[71]

In addition, the courts generally have evidenced a disinclination to enforce such forfeiture provisions when enforcement would substantially impair or deprive the bankrupt of its principal asset, thereby frustrating the arrangement, reorganization, or bankruptcy.[72] Courts have also frequently achieved the same results under state law by finding that the landlord had waived his contractual rights to enforce a forfeiture clause,[73] or by a technical application of state law regarding the terms of the forfeiture provision.[74]

However, in *Conqueror Films, Inc. v. Camelot Entertainment, Inc.*,[75] the court permitted the enforcement of a forfeiture provision, even though enforcement deprived the debtor of its sole "asset." The debtor was the lessee of a motion picture. The motion picture constituted the lessee's sole method of earning money to pay its creditors in the arrangement proceeding. The lease agreement provided that it would terminate automatically in the event the lessee availed itself of any remedy under the Act. Upon the initiation of a chapter XI proceeding, the lessor sought to terminate the lease agreement and to recover all prints of the motion picture. The lessee opposed the claim, arguing that its sole asset was the distribution rights, and that its chances to "achieve an adjustment of its unsecured debt" would be nullified if the repossession were permitted.

Although section 70b clearly applies to an arrangement proceeding, the court noted that the need to give strict adherence to its provisions was not as compelling in an arrangement as in a reorganization. A reorganization is a pervasive statutory method of rehabilitating a financially distressed corporation through the rearrangement of all of its debts. Reorganization of a debtor without its

---

71. Smith v. Hoboken R.R. Warehouse & S.S. Connecting Co., 328 U.S. 123 (1946).

72. Pennsylvania Real Estate Inv. Trust v. Fountainbleau Hotel Corp., 515 F.2d 913 (5th Cir. 1975); Queens Blvd. Wine v. Blum, 503 F.2d 202 (2d Cir. 1974); *In re* Fleetwood Motel Corp., 335 F.2d 857 (3d Cir. 1964).

73. Larkins v. Sills, 377 F.2d 1 (5th Cir. 1967); *In re* Speare, 360 F.2d 882 (2d Cir. 1966); B.J.M. Realty Corp. v. Ruggieri, 338 F.2d 653 (2d Cir. 1964); Geraghty v. Kiamie Fifth Ave. Corp., 210 F.2d 95 (2d Cir. 1954).

74. Pennsylvania Real Estate Invest. Trust v. Fountainbleau Hotel Corp., 515 F.2d 913 (5th Cir. 1975).

75. No. 75-1186 (M.D. Fla. Nov. 15, 1976).

sole or principal asset is usually impossible. An arrangement proceeding, on the other hand, is a simpler statutory device to adjust and settle unsecured debts.

The court held that in an arrangement proceeding the provisions of section 70b should be used only as a "temporary aid to assist the debtor to find an alternative solution to its problem."[76] The franchise agreement conferred no property right upon the lessee, and the motion picture was therefore never an "asset" of the lessee. The court emphasized that upon confirmation the lessee would lose its distribution contract anyway since the lessor then would be free to cancel it and recover the prints. As a result, there was no reason to conclude that a refusal to enforce the forfeiture provision would in any way assist in effectuating a successful plan of arrangement. The court noted that the fact that its decision destroyed the lessee's chances to effectuate an arrangement was "of no consequence."[77]

### C. *Settlors*

In *Brigadier Industries Corp. v. Gorman (In re Triangle Indemnity Corp.)*,[78] a decision of first impression, the court concluded that the tracing of trust funds through a commingled bank account was not interrupted or defeated by another bank's wrongful dishonor of a deposit check which was to be included in the commingled account. The bankrupt acted as a selling agent for the plaintiff creditor who made mobile homes. The bankrupt sold a mobile home to a third party who paid the purchase price to the bankrupt for payment to the creditor. The purchase money was deposited by the bankrupt in his own account at a local bank. The bankrupt later withdrew slightly more than the purchase money from that account and put it in another bank. It then deposited another large check in the latter bank account. The deposit of this check should have maintained the bankrupt's balance in the latter bank at far more than the purchase money. However, the large deposit check was dishonored, resulting in a balance less than the purchase price. The dishonor was improper, however, and the large check was later honored, resulting in a balance greater than the purchase money.

The creditor claimed against the estate for the purchase money

76. *Id.* at 4.
77. *Id.* at 5.
78. 8 C.B.C. 167 (M.D. Fla. 1976).

on the theory that the bankrupt held the money in trust for him. Since a bankruptcy trustee does not succeed to the title to trust assets of the bankrupt,[79] the funds ordinarily would not be affected by the bankruptcy. However, the funds had been commingled by the bankrupt in its second bank account. The burden of tracing commingled funds was upon the beneficiary.[80] With respect to any trust funds that he was unable to identify and trace, he would have to prove his claim as a general creditor against the debtor's estate.[81]

In tracing commingled funds, the general principle is that so long as a commingled account is not depleted below the trust amount, the account balance is presumed to include the trust money. Withdrawals are presumed to have been only from funds that properly could be used by the bankrupt.[82] In this case, the court applied a clearly correct, but unprecedented rule in holding that the wrongful dishonor of a deposit check which temporarily resulted in the "depletion" of the commingled account below the amount of the trust funds had no effect upon the traceability of the funds in trust.

## III. JURISDICTION OF BANKRUPTCY COURT

### A. *Consent to Jurisdiction by Counterclaim*

Generally, a bankruptcy court's summary jurisdiction is limited to the adjudication of rights and claims pertaining to property in the actual or constructive possession of the bankruptcy court.[83] When a controversy involves property in the actual or constructive possession of a third person asserting a bona fide adverse claim, the bankruptcy court may not assert summary jurisdiction without the claimant's consent. Absent consent, suit must be brought in a court of appropriate jurisdiction other than the bankruptcy court.[84] Un-

79. Elliott v. Bumb, 356 F.2d 749 (9th Cir. 1966), *cert. denied sub nom.* Schutzbank v. Elliott, 385 U.S. 829 (1966); Gulf Petroleum, S.A. v. Callazo, 316 F.2d 257 (1st Cir. 1963); American Serv. Co. v. Henderson, 120 F.2d 525 (4th Cir. 1941); Creel v. Birmingham Trust Nat'l Bank, 383 F. Supp. 871 (N.D. Ala. 1974).

80. Elliott v. Bumb, 356 F.2d 749 (9th Cir. 1966).

81. Sonnenschein v. Reliance Ins. Co., 353 F.2d 935 (2d Cir. 1965); Gulf Petroleum, S.A. v. Callazo, 316 F.2d 257 (1st Cir. 1963).

82. Voltz v. Peppas, 4 F. Supp. 915 (N.D. Ohio 1933).

83. Hebert v. Crawford, 288 U.S. 204 (1913). For a more complete discussion of summary jurisdiction see Suskin & Swing, *Ownership as a Basis for Summary Jurisdiction in Chapter XI Arrangements*, 31 U. MIAMI L. REV. 307 (1977).

84. Harrison v. Chamberlin, 271 U.S. 191 (1926); Jan C. Uiterwyk Co. v. Brock (*In re* Naviera Azta, S.A.), 500 F.2d 390 (5th Cir. 1974).

like the federal district courts, subject matter jurisdiction may be conferred upon the bankruptcy court by the third party's consent or waiver.[85]

In *Nathan v. Austin Travel Corp. (In re T.M.P., Inc.)*,[86] another case of first impression, a creditor who had not filed a proof of claim was held to have consented to the jurisdiction of the bankruptcy court by counterclaiming against the trustee in an adversary proceeding instituted by the trustee. The trustees sued the creditor of the bankrupt in the bankruptcy court to recover an account receivable. Although the creditor objected properly to the court's jurisdiction, he also filed a counterclaim for affirmative relief against the trustee. The court viewed the counterclaim as substantially a proof of claim since it sought a money judgment from the estate. The court held that by filing the counterclaim the creditor waived his right to challenge the court's subject matter jurisdiction. The court reasoned that a dismissal of the trustee's action would have allowed the counterclaim to remain within the court's jurisdiction. That result was viewed as "anomalous."[87]

The court in *Nathan* first distinguished decisions under Federal Rule of Civil Procedure 13, which governs counterclaims in civil actions. Under that rule, it has been held that objections to jurisdiction over the *person* are waived by filing a counterclaim only when the counterclaim is permissive.[88] However, counterclaims in bankruptcy are governed by Bankruptcy Rule 713, which affirmatively adopts Federal Rule of Civil Procedure 13, with the important exception that *all* counterclaims are permissive.

Notwithstanding this distinction, the bankruptcy courts generally have employed a similar, although not identical principle. Thus, while all counterclaims are permissive under Bankruptcy Rule 713, it generally has been held that the bankruptcy court lacks jurisdiction over a counterclaim filed by the trustee after the creditor has filed a proof of claim, if the counterclaim does not arise out of the same operative facts as the proof of claim.[89] Similarly, the

---

85. 1 COLLIER ON BANKRUPTCY, *supra* note 28, ¶ 2302[2].

86. No. 76-95 (M.D. Fla. Aug. 3, 1976).

87. *Id.* at 4.

88. Dragor Shipping Corp. v. Union Tank Car Co., 378 F.2d 241 (9th Cir. 1967); Hasse v. American Photo. Corp., 299 F.2d 666 (10th Cir. 1962).

89. Associate Fundings, Inc. v. Phipps (*In re* Los Angeles Trust Deed & Mortgage Exch.), 464 F.2d 1136 (9th Cir. 1972); Cherno v. Engine Air Serv., Inc., 330 F.2d 191 (2d Cir. 1964); Peters v. Lines, 275 F.2d 919 (9th Cir. 1960).

Fifth Circuit has held that by filing a proof of claim, a claimant (creditor) does not submit to summary jurisdiction allowing the recovery of a preference from him, when the preference does not arise out of the same transaction involved in the proof of claim.[90] This approach is obviously similar to the practice under Federal Rule of Civil Procedure 13, since the test of the permissive or mandatory nature of a counterclaim under that rule is whether the counterclaim arises out of the same transaction as the complaint.

The reasoning in *Nathan* is somewhat unclear. It seems to suggest that it is improper to exercise summary jurisdiction over a proof of claim without exercising such jurisdiction over a trustee's claim against the same creditor. Yet this practice was followed in *B.F. Avery & Sons Co. v. Davis*,[91] which was reaffirmed in *United States v. Tavormina (In re Airmotive Suppliers, Inc.)*.[92] Neither case was mentioned in *Nathan*. The application of the *Avery* and *Airmotive* principle also was intimated in *Gill v. Phillips*,[93] where the claim and counterclaim arose from the same transactions. The *Nathan* case, while citing *Gill*, does not say whether the trustee's claim and the counterclaim arose out of the same transaction. To the extent that the decision implies that the court could exercise summary jurisdiction over the trustee's claim, even if it did not arise from the same transaction as the creditor's counterclaim, it appears to be in conflict with the *Avery*, *Gill*,, and *Airmotive* decisions.

*Nathan* holds a message for the creditor who is sued improperly in the bankruptcy court by the trustee. Unless it is preferable to consent to the court's summary jurisdiction, only an objection to the court's jurisdiction should be filed in response to the trustee's complaint, even though the creditor has a valid claim against the estate. A counterclaim could result in a finding that the creditor has consented to jurisdiction over the trustee's claim, even if an objection was filed. Where the estate may have a claim against the creditor that could exceed greatly the probable dividends from the filing of a proof of claim, it even may be advisable to file no proof of claim if the trustee's potential claim arises out of the same transaction or facts as the creditor's claim, or if it involves the same property.

90. B.F. Avery & Sons Co. v. Davis, 192 F.2d 255 (5th Cir. 1951), *cert. denied*, 342 U.S. 945 (1952).

91. *Id.*

92. 519 F.2d 1102 (5th Cir. 1975).

93. 337 F.2d 258 (5th Cir. 1964).

A more logical decision was reached in *In re Golf Resources, Inc.*,[94] where a creditor brought an adversary proceeding to reclaim vending machines which were sold to the debtor under an installment sale contract. The debtor counterclaimed seeking damages for a breach of warranty on the machines. The creditor sought dismissal of the counterclaim on the ground that the court lacked jurisdiction over the subject matter of the counterclaim. The court held that the creditor initially invoked the court's jurisdiction and had thereby consented to its summary jurisdiction over all matters arising out of the transaction upon which the creditor sued. The decision was consistent with *Avery* and *Gill* in holding that summary jurisdiction over a counterclaim was proper when the subject matter of the counterclaim was the same as that of the original claim. The result was correct since the counterclaim for the breach of warranty on the vending machines involved the same property and the same transaction.[95]

### B. *Jurisdiction to Determine Dischargeability of Tax Liabilities*

In *Murphy v. IRS*,[96] the Fifth Circuit ruled for the first time that a bankruptcy court had jurisdiction to determine the dischargeability of a federal tax liability, even though the government had not filed a proof of claim for the tax. In a subsidiary issue, also one of first impression in the Fifth Circuit, the court ruled that the one hundred percent penalty tax imposed by section 6672 of the Internal Revenue Code was not dischargeable in bankruptcy.

Section 6672 imposes a "penalty" upon any person who fails in his responsibility to collect withholding (payroll) taxes and to pay them over to the government. The "penalty" is equal to the total taxes not withheld or paid over. Murphy, a corporate officer who did not pay withholding taxes to the government, was adjudicated bankrupt and discharged. The United States filed no proof of claim for the penalty tax, but the bankrupt asked the court to determine its dischargeability as a debt. The government argued that the court lacked jurisdiction to determine the dischargeability of the penalty tax because the government had filed no proof of claim for it. The

94. No. 75-462-T (M.D. Fla. Dec. 8, 1976).
95. *See generally In re* The All American Burger, Inc., 2 Bankr. Ct. Dec. 763 (C.D. Cal. 1976); SEC v. Morgan Kennedy & Co., FED. SEC. L. REP. (CCH) ¶ 94,568 (S.D.N.Y. 1974).
96. 533 F.2d 940 (5th Cir. 1976).

bankruptcy court held that it had jurisdiction and that the penalty tax was dischargeable. The district court upheld the bankruptcy court's decision on jurisdiction but reversed on the ground that the debt was not dischargeable.[97] The district court's decision was affirmed by the Fifth Circuit.[98]

By holding that the bankruptcy court had jurisdiction over the tax issue, regardless of the filing of a proof of claim by the government, the Fifth Circuit joined three other circuits which had previously so held.[99] Their decisions drew upon the language of section 2a (2A) of the Act, which gives the bankruptcy court jurisdiction to hear and determine "any question arising as to the amount or legality of any unpaid tax . . . which has not prior to bankruptcy been contested before and adjudicated by a judicial or administrative tribunal."[100] Such a literal reading of the statute conflicts with the Report of the Senate Finance Committee involving the section.[101] However, the general opinion has been that the Senate Committee Report does not accurately reflect the legislative intent because the bill originated in the House rather than the Senate. Moreover, the Committee's recommendations were ultimately rejected, although the bill passed.

With regard to the issue of dischargeability of corporate officer liability under section 6672, the Fifth Circuit in *Murphy* adopted the opinion of the district court which had relied upon the case of *Sherwood v. United States*.[102] Under the Bankruptcy Act so-called

---

97. 381 F. Supp. 813 (N.D. Ala. 1974).

98. 533 F.2d 940 (5th Cir. 1976).

99. Bostwick v. United States, 521 F.2d 741 (8th Cir. 1975); Gilliam v. United States, 519 F.2d 407, 412 (9th Cir. 1975); *In re* Century Vault Co., 416 F.2d 1035 (3d Cir. 1969). Several district courts have held similarly. *E.g.*, *In re* Savage, 329 F. Supp. 968 (C.D. Cal. 1971); United States v. Standard Milling Co., 324 F. Supp. 386 (N.D. Tex. 1970); *In re* Curtis, 69-1 U.S.T.C. ¶ 9433 (W.D. Mich. 1969) (referee). *Contra*, *In re* Zook, 74-1 U.S.T.C. ¶ 9399 (C.D. Cal. 1974).

100. Bankrutpcy Act § 29(A2).

101. S. Rep. No. 999, 89th Cong., 2d Sess. 11, *reprinted in* [1966] U.S. CODE CONG. & AD. NEWS 244Z, 245Z, observed that: "The committee understands that this amendment makes no change in present law under which a bankruptcy court cannot adjudicate the merits of any claim, including a Federal tax claim, which has not been asserted in the bankruptcy proceeding by the filing of a proof of claim."

The Fifth Circuit has previously recognized this conflict. Gilbert v. United States (*In re* Statmaster Corp.), 465 F.2d 978 (5th Cir. 1972); *accord*, Bostwick v. United States, 521 F.2d 741, 742-43 (8th Cir. 1975); *In re* Durensky, 377 F. Supp. 798 (N.D. Tex. 1974), *appeal dismissed*, 519 F.2d 1024 (5th Cir. 1975). *See generally* Kennedy, *The Bankruptcy Amendments of 1966*, 1 GA. L. REV. 49, 159 n.41, 172-73 (1967).

102. 228 F. Supp. 247 (E.D.N.Y. 1964).

"true penalties" owed the government are neither provable nor allowable in bankruptcy, except for the amount of "pecuniary loss" actually suffered by the government from the transaction which gave rise to the penalty.[103] Since "true penalties" are not provable or allowable in bankruptcy, they also are not dischargeable in bankruptcy. The *Sherwood* court pointed out that, if an actual pecuniary loss to the government is included in a tax penalty, it is allowable under section 57 of the Act. The loss also is provable by implication under section 63 of the Act, and therefore is dischargeable. Since the failure to withhold or pay over payroll taxes results in a pecuniary loss to the government, the "penalty" imposed by section 6672 ordinarily is allowable, provable, and dischargeable. However, according to the *Murphy* and *Sherwood* decisions, although section 6672 of the Internal Revenue Code imposes what it calls a "penalty," it is really a *shifted tax burden*, since it only serves to force the irresponsible corporate officer to pay the tax which the corporation should have paid. Since the section 6672 "penalty" is a *tax*, not just a "pecuniary loss penalty," it is nondischargeable because section 17 excludes from dischargeability a provable debt due as a *tax* to the United States.

Before the *Murphy* decision was reported, the United States District Court for the Middle District of Florida reached a similar result. In *Eberly v. United States*,[104] the district court reversed a bankruptcy court's dismissal of an action involving the dischargeability of a section 6672 liability. The bankrupt was an officer of a corporation, and was in a position similar to the corporate officer in *Murphy*. The bankrupt filed a voluntary petition listing taxes due the United States, but the government did not file a proof of claim. The bankrupt filed a claim on behalf of the government, assumedly under section 57i of the Act,[105] and sought a determination of the dischargeability of the tax as a debt.

The bankruptcy judge dismissed the complaint on the ground that it alleged no facts that would support a "genuine contention"

103. Section 57j of the Act provides in pertinent part that "[d]ebts owing to the United States . . . as a penalty . . . shall not be allowed, except for the amount of the pecuniary loss sustained by the act . . . out of which the penalty . . . arose."

104. 8 C.B.C. 633 (M.D. Fla. 1976).

105. Section 57i provides in pertinent part that "[w]henever a creditor whose claim against a bankrupt estate is secured, in whole or part, by the individual undertaking of a person, fails to prove and file that claim, that person may do so in the creditor's name." Similar provisions are found in Bankruptcy Rules 11-33(d) and 304.

that the debt was dischargeable. The court viewed the complaint as an application for a declaratory judgment of a potential tax liability, an action which is unavailable under the Federal Declaratory Judgments Act.[106]

In reversing, the district court held, as in *Murphy*, that section 2a(2A) of the Act grants the bankruptcy court jurisdiction to determine the amount or legality of any unpaid tax, regardless of whether the government has filed a proof of claim.[107] In addition, the court held that the petition was not subject to dismissal simply because it did not allege facts showing that the tax liability was dischargeable. The court pointed out that the purpose of the dischargeability provision of section 17c of the Act was simply to determine dischargeability *for or against* the debtor. Therefore, it was unnecessary to allege facts showing that the tax liability was dischargeable.[108]

The court also dispensed with the argument by the government that sovereign immunity and the Declaratory Judgment Act's proscription of declaratory tax judgments barred the bankruptcy court from granting the relief which the complaint sought. The court ruled that since section 2a(2A) and section 17c of the Act give the court jurisdiction to determine the dischargeability of any tax claim, independent of the government's consent to jurisdiction, the position taken by the government "has simply been overridden by Congress."[109]

### C. *Power to Invoke Jurisdiction*

In *In re Fidelity Development*,[110] a bankruptcy court stated that a Florida corporation undergoing dissolution proceedings can still initiate chapter XI proceedings. The corporation was dissolved by the Florida Secretary of State under the provisions of the old corporation law.[111] A creditor contended that because the corporation was

106. 28 U.S.C. § 2201 (1970) provides in part: "In a case of actual controversy within its jurisdiction, *except with respect to Federal taxes*, any court of the United States . . . may declare the rights and other legal relations of any interested party . . . ." (Emphasis added).

107. *Accord*, Murphy v. IRS, 533 F.2d 940 (5th Cir. 1975); Bostwick v. United States, 521 F.2d 741 (8th Cir. 1975).

108. Indeed, section 17c(3) of the Act states that after a hearing the court is to determine "the dischargeability of *any* debt for which an application for such determination has been filed." (Emphasis added).

109. Eberly v. United States, 8 C.B.C. 633, 637 (M.D. Fla. 1976).

110. 8 C.B.C. 412 (M.D. Fla. 1976).

111. Law of June 15, 1953, ch. 28170, § 608.30, [1953] Fla. Laws 650 (repealed 1975).

in dissolution, it no longer possessed the capacity or authority to file a petition under chapter XI. The court held that the secured creditor who attempted to challenge the ability of the debtor to seek chapter XI relief lacked standing to challenge the capacity of the debtor to seek relief. According to the court, standing was limited to parties, such as stockholders, whose rights were affected directly by the petition. However, assuming that standing was present, the court stated that a corportion in dissolution under chapter 608 could file a chapter XI petition.

The legal existence and the capacity of a corporation to function is governed in bankruptcy by the laws of the state that created it.[112] Under the old Florida corporation law every dissolved corporation was allowed to continue to operate as a body corporate for three years after dissolution, but solely for the purposes of satisfying its liabilities, selling and conveying its property, and dividing its remaining assets among the shareholders.[113] The corporate directors were designated as a "Board of Trustees" for the corporate property. They were granted the power and duty to collect debts, to collect property belonging to the corporation, to pay debts and claims as far as possible, and to prosecute and defend all suits arising after dissolution, as well as suits then pending.[114] On the basis of these provisions the court in *Fidelity Development* concluded that a dissolved Florida corporation could, through its trustees, sue, be sued, collect debts, satisfy debts, and liquidate assets, all of which are "the very essence of a bankruptcy proceeding instituted by voluntary bankrupt."[115] Although the corporation law under which *Fidelity Development* was decided has been superseded by the new Florida General Corporation Act, the dissolution provisions of the new Act do not differ significantly from those of its predecessor, and the same results should be reached under the new Act.[116]

112. *See* Chicago Title & Trust Co. v. 4136 Wilcox Bldg. Corp., 302 U.S. 120 (1937).

113. Law of June 15, 1953, ch. 28170, § 608.30(2)a, (3)a, [1953] Fla. Laws 650 (repealed 1975).

114. *Id.*

115. *In re* Fidelity Dev., 8 C.B.C. 412, 414 (M.D. Fla. 1976).

116. Florida Statutes section 607.301(1) (1975) also designates the directors of the corporation at the time of its dissolution as the board of trustees for corporate property. Florida Statutes section 607.297 (1975) provides that the dissolution of a corporation shall not take away or impair any remedy available to the corporation for any rights, claim, or liability incurred prior to dissolution, so long as the proceeding thereon is commenced within three years after dissolution.

The court in *Fidelity Development* distinguished the decision in *Chicago Title & Trust Co. v. 4136 Wilcox Building Corp.*,[117] in which the United States Supreme Court held that under Illinois law a corporation in dissolution for over two years could not initiate a reorganization proceeding. In *Chicago Title & Trust*, the state corporation law deprived the corporation of the capacity to initiate legal proceedings. In addition, the decision involved a proposed reorganization, in which the *corporate* existence of the debtor was of prime significance. Several prior decisions,[118] including a Fifth Circuit decision,[119] have recognized the logic of this rationale. These decisions, however, were not cited to the bankruptcy court in *Fidelity Development*.

Section 5 of the Bankruptcy Act governs who may become a bankrupt or a debtor in an arrangement or reorganization. Section 4a of the Act provides that any "person" is entitled to become a voluntary bankrupt. Under section 1(23), a "person" includes corporations, which in turn are defined in section 1(8) as "all bodies having any of the powers and privileges of private corporations not possessed by individuals or partnerships."[120] Thus it appears that as long as the body in dissolution possesses "any" power or privilege of any private corporation not possessed by individuals or partnerships, it may file a voluntary petition. The limited liability of a corporation therefore should suffice to maintain "corporation" status.[121] However, state law must still supply the power to initiate the proceedings. Some decisions have indicated that state dissolution laws cannot supersede the provisions of the Act. The result of such cases has been that the corporation dissolved under state law may still avail itself of the rehabilitative provisions of the Bankruptcy Act.[122] Such decisions seem to be overruled by *Chicago Title & Trust Company*.

It has also been suggested that after dissolution, and even after the statutory life of the dissolved corporation has ended, a petition under the Act might be filed in a case where the remaining share-

117. 302 U.S. 120 (1937).

118. Chicago Title & Trust Co. v. Ryan (*In re* Midwest Athletic Club), 161 F.2d 1005 (7th Cir. 1947); *In re* Vassar Foundry Co., 293 F. 248 (E.D. Mich. 1923).

119. McClung v. Hill, 96 F.2d 236 (5th Cir. 1938).

120. Bankruptcy Act § 1(8).

121. *See generally, In re* Carthage Lodge, 230 F. 694 (N.D.N.Y. 1916).

122. *E.g.*, Hammond v. Lyon Realty Co., 59 F.2d 592 (4th Cir. 1932).

holders act in unison under a trade name and constitute an unincorporated association.[123]

## IV. Valuation of Security

In the case of *In re Aldersgate Foundation, Inc.*,[124] the court held that the capitalization of earnings standard of valuation, which is traditionally employed in entity valuation under chapter X, need not be applied in all collateral valuation proceedings to the exclusion of other methods of valuation. The debtor was a tax-exempt, nonprofit organization, which had constructed and intended to operate retirement communities in four Florida locations. Bonds were issued to finance construction. Each bond was secured by a first mortgage on the particular project for which it was issued.

The trustee initiated valuation proceedings under section 197 of the Act and under Bankruptcy Rule 10-302(b). Section 197[125] requires the court to divide the debtor's creditors and stockholders into classes according to the nature of their claims or stock and to determine summarily the value of the security for each. Rule 10-302(b)[126] authorizes the court to hold a hearing to determine the value of a security interest and to allow the claim as unsecured to the extent that it exceeds its security.

The Securities and Exchange Commission, which is a necessary party in reorganization proceedings, argued that the security for the bonds could be valued only through a capitalization of earnings approach. The court rejected the SEC's contention, employing in-

123. *See e.g., In re* Int'l Sugar Feed Co., 23 F. Supp. 197 (D. Minn. 1938); *In re* Booth's Drug Store, Inc., 19 F. Supp. 95 (W.D. Va. 1937).

124. No. 74-383 (M.D. Fla. June 10, 1976).

125. Section 197 of the Act provides:

> For the purposes of the plan and its acceptance, the judge shall fix the division or creditors and stockholders into classes according to the nature of their respective claims and stock. For the purposes of such classification, the judge shall, if necessary, upon the application of the trustee, the debtor, any creditor, or an indenture trustee, fix a hearing upon notice to the holders of secured claims, the debtor, the trustee, and such other persons as the judge may designate, to determine summarily the value of the security and classify as unsecured the amount in excess of such value.

126. Bankruptcy Rule 10-302(b) provides in pertinent part:

> [T]he court shall, if necessary, on application of any party in interest, hold a hearing on such notice as the court may direct, to determine the value of the security interest and allow the claim as unsecured to the extent it is enforceable for any excess of the claim over such value.

stead a mixture of such recognized valuation methods as cost-of-replacement and comparable sales, in addition to the capitalization of earnings method.

The capitalization of earnings method has long been the only acceptable method in computing the "entity" value of a reorganization debtor.[127] Such valuations as those conducted under section 221(2) of the Act, allow confirmation of a reorganization plan only if the plan is "fair and equitable." Whether a plan is fair and equitable depends principally upon the income potential of the corporation if it were reorganized. A determination must be made whether the stockholders will be permitted to participate in the plan after secured and unsecured creditors are secured by the plan. Creditors and stockholders are classified separately under section 197. Stockholders rank below all creditors. Creditors are entitled to be secured fully by the plan (which may be partly through the issuance of stock) to the exclusion of any stockholder.[128] Unless the "going concern" value of the corporate debtor is employed — usually resulting in a higher value than other methods — stockholders may be excluded unfairly from the plan.[129] In such a case the fair and equitable requirement of section 221(2) would not be satisfied.

It is clear that this standard is the only proper valuation method under section 221(2).[130] Whether it must be applied to a valuation proceeding under section 197, the purpose of which is to value specific collateral in order to determine the extent to which each debtor is secured, is not stated or understood clearly. As the *Aldersgate* court noted, section 197 clearly contemplates the valuation of a particular asset, not the entire debtor. It is used for the purpose of determining what creditors are secured and to what extent they are secured, and not for the purpose of determining whether the plan is "fair and equitable."

The *Aldersgate* court further rejected a strict capitalization of earnings approach to property which either had no history of income

127. Protective Comm. for Independent Stockholders v. Anderson, (*In re* TMT Trailer Ferry, Inc.), 390 U.S. 414 (1968); Consolidated Rock Prods. Co. v. DuBois, 312 U.S. 510 (1941); Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939).

128. *See* Continental Ins. Co. v. Louisiana Oil Ref. Corp., 89 F.2d 333 (5th Cir. 1937), *aff'd sub nom.* Bache v. Louisiana Oil Ref. Corp., 97 F.2d 445 (5th Cir.), *cert. denied*, 305 U.S. 622 (1938).

129. Consolidated Rock Prods. Co. v. DuBois, 312 U.S. 510 (1941); Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939); North Pac. Ry. v. Boyd, 228 U.S. 482 (1913).

130. Case v. Los Angeles Lumber Prods. Co. 308 U.S. 106 (1939).

production, or which produced income only in conjunction with property not covered by the security interest. Such a distinction has been recognized in theory under section 221(2) where the corporate debtor's assets are sufficiently nonproductive to render a capitalization of earnings approach "futile," or where the liquidation value of the debtor's assets exceed the debtor's going concern value.[131] Only two of the Aldersgate properties had any income-producing history. The income-producing potential of the two other properties was extremely questionable. As a result, the court employed several recognized asset valuation methods, including capitalization of earnings. The court emphasized the capitalization of earnings method in valuing the two income-producing properties.

The court rejected the SEC's reliance upon *In re Equity Funding Corp.*,[132] which held that the term "value of the security," as used in section 197, refers to a value predicated upon a capitalization of future earnings. The court in *Equity Funding* faced an argument similar to that presented in *Aldersgate*. Several creditors argued that the section 197 value of their stock depended upon the amount they could have realized by selling it, not a reorganization value based upon capitalized earnings. The court disagreed on an important basis. The security involved constituted all the outstanding stock of the reorganization debtor. The court concluded that the term "value of the security" in section 197 referred to a capitalized earning value "when the collateral to be valued is the entire outstanding stock [of the corporation]."[133]

The court in *Aldersgate* pointed out that because the "security" involved in the *Equity Funding* decision was all the corporate stock, the value of which could *only* be measured by the corporation's earning potential, it was completely proper to do so. However, the court concluded that to apply a similar rule to the valuation of generally nonproductive tangible assets would be absurd.

## V. PRIVILEGES

### A. *Newsman's Privilege*

Also in *In re Aldersgate Foundation Inc.*,[134] the court for the first

131. *See* 6A COLLIER ON BANKRUPTCY, *supra* note 28, ¶ 11.05, at 604.
132. 391 F. Supp. 768 (C.D. Cal. 1975).
133. *Id.* at 773.
134. No. 74-383 (M.D. Fla. June 10, 1976).

time considered the parameters of the so-called "newsman's privilege," in a reorganization proceeding. The trustee sought to depose a newsman who had quoted a party interested in the reorganization as stating that the reorganization plan would not be accepted. The source was identified in the newspaper report. The trustee contended that this statement was in violation of the no-solicitation rule.[135] The source denied making the statement. The trustee sought to determine whether the report was accurate. Criminal sanctions for the claimed violation were not involved.

The court granted the reporter's motion for a protective order on the narrow ground that under the circumstances a violation of the no-solicitation rule was inconsequential. The court had not approved a plan to be submitted to the creditors. However, the court went on to make a number of observations covering the so-called "newsman's privilege" in bankruptcy proceedings. The court observed that the United States Supreme Court's decision in *Branzburg v. Hayes*[136] which denied such a privilege, did not control in a civil matter. *Branzburg* involved the privilege claim of a newsman who refused to tell a grand jury the names of persons who used illegal drugs in his presence and whose criminal actions were reported in his newspaper. The Supreme Court held that the reporter was not entitled to withhold from the grand jury the names of persons whom he had seen commit crimes. The Court founded the decision upon the constitutionally mandated existence and role of the grand jury in protecting the public from crimes. The Court acknowledged that the news gathering process "qualifies" for first

---

135. Section 176 of the Act provides:

> No person shall, without the consent of the court, solicit any acceptance, conditional or unconditional, of any plan, or any authority, conditional or unconditional, to accept any plan, whether by proxy, deposit, power of attorney or otherwise, until after the entry of an order approving such plan and the transmittal thereof to the creditors and stockholders, as provided in Section 175 of this Act; and any such authority or acceptance given, procured, or received by reason of a solicitation prior to such approval and transmittal shall be invalid, unless such consent of the court has been so obtained.

Bankruptcy Rule 10-304 provides:

> No person shall, without the consent of the court, solicit any acceptance or rejection, conditional or unconditional, of any plan, whether by proxy, deposit, power of attorney or otherwise, until after the entry of an order approving such plan pursuant to Rule 10-303(c) and the transmittal thereof to creditors and stockholders pursuant to Rule 10-303(e). Rule 10-211(b) applies to any violation of this rule.

136. 408 U.S. 665 (1972).

amendment protection, but that the interest of the state in grand jury proceedings outweighed the first amendment rights of newsmen. *Branzburg* was the last significant statement by the Supreme Court on the topic.

Although *Branzburg* does not control in civil matters, it does not follow necessarily that a newsman always possesses the privilege to withhold information from civil courts. The "newsman's privilege" has been a qualified privilege which has been measured differently in civil cases than in criminal cases. The news gathering process has been held sufficiently important to prevail over the need of a party to civil litigation to force a breach of a confidence.[137] Generally, the privilege has been respected in civil pretrial discovery. Discovery is usually denied when it is impossible for the party seeking discovery to demonstrate that his need for the information is compelling, is crucial to his case, and is not practically accessible elsewhere.[138] It has been held, however, that the privilege exists only when the requested information "directly leads to the disclosure of confidence."[139] Allegations that production of the requested information *could* result in the discovery of a confidential news source have been insufficient.

The court in *Aldersgate* recognized correctly that there was little reason to recognize the privilege where the purpose of discovery was to verify the accuracy of information already published by an identified source. To do otherwise would go further than seems reasonable in preventing a chilling effect upon the exercise of first amendment freedoms by the press. Indeed, some state "shield laws," enacted to confer a "qualified" newsman's privilege, protect only the source's identity, not his information.[140] Others do not confer a true "privilege," but immunize from contempt sanctions newsmen refusing to divulge *sources* of published information and *all* unpublished information.[141] Still others simply protect from contemp refusals to disclose sources of information.[142] Florida has no

137. Gilbert v. Allied Chem. Corp., 411 F. Supp. 505 (E.D. Va. 1976); Loadholtz v. Fields, 389 F. Supp. 1299 (M.D. Fla. 1975).

138. Gilbert v. Allied Chem. Corp., 411 F. Supp. 505 (E.D. Va. 1976); Loadholtz v. Fields, 389 F. Supp. 1299 (M.D. Fla. 1975).

139. Gilbert v. Allied Chem. Corp., 411 F. Supp. at 511.

140. For a discussion of these laws see Forest Hills Util. Co. v. City of Heath, 37 Ohio Misc. 30, 302 N.E.2d 593 (Ohio C.P. 1973).

141. Rosato v. Superior Court, 51 Cal. App. 3d 190, 124 Cal. Rptr. 427 (Ct. App. 1975).

142. Apicella v. McNeil Labs, Inc., 66 F.R.D. 78 (E.D.N.Y. 1975) (New York statute).

shield law. If it did, however, Federal Rule of Evidence 501 could make it applicable to civil adversary proceedings in the bankruptcy courts.[143]

Although *Aldersgate* was itself founded upon a narrow ground, it evidences an adoption by the bankruptcy court of the rationale which upholds the newsman's right to withhold confidential sources of information and preparatory notes in civil litigation, except when the party seeking the information can demonstrate a *compelling* need for the information.[144] The definition of a compelling need in a bankruptcy contest must await future decisions.

### B. *Attorney-Client Privilege*

In *Gorman v. Martinez (In re Amjoe, Inc.)*,[145] a case of first impression in the nation, the court held that a bankruptcy trustee could waive the bankrupt's attorney-client privilege in an adversary proceeding. In administering the estate, the trustee objected to the proofs of claim filed by a creditor. The trustee also filed a counterclaim against Martinez for damages. In the course of the proceedings, the trustee scheduled the deposition of the bankrupt's former attorney. Both the attorney and the defendant raised the attorney-client privilege. An officer of the bankrupt corporation signed an affidavit invoking the privilege. The court ruled that the trustee, under the circumstances, could waive the attorney-client privilege on behalf of the bankrupt, and that the bankrupt could not override the trustee's waiver.

The court observed that an adjudication of bankruptcy has no legal effect upon the existence of the bankrupt corporation. It continues to transact business while its affairs are being conducted in the bankruptcy court. The defendant argued that the corporate

143. Federal Rule of Evidence 501 provides that state rules of "privilege" are to be applied in proving or disproving "an element of a claim or defense as to which State law supplies the rule of decision." When statutes create not a privilege, but only immunity from contempt, the application of Rule 501 is uncertain. *See* Appicella v. McNeil Labs, Inc., 66 F.R.D. 78, 84 (E.D.N.Y. 1975).

144. *See* note 136 *supra* and accompanying text.

145. No. 75-265-T (M.D. Fla. Oct. 12, 1976). The law firm of the authors of this article represents a party in this case. The decision of the bankruptcy judge is on appeal. Although the decision of the bankruptcy judge appears to the authors to be sufficiently significant to merit its inclusion in this article, the authors offer no analysis or comment upon the correctness of the decision. Only the decision of the bankruptcy judge and the rationale employed by him in reaching his decision, as expressed in his written opinion, are reported.

bankrupt therefore retained its power to invoke the attorney-client privilege. The court noted that section 70a(3) of the Act gives the trustee those " 'powers which the bankrupt might have exercised for his own benefit.' "[146] The court stated that the power referred to in section 70a(3) does not include powers that are strictly personal to the bankrupt and do not relate directly to property of the estate.[147] However, it concluded that the attorney-client privilege "lack[ed] the characteristic of a personal privilege in the true sense."[148] Thus, the trustee could waive it.

The court in *Gorman* relied upon *Weck v. District Court*.[149] In that decision, the Colorado Supreme Court held that a trustee for a bankrupt corporation succeeded to the powers of the corporate board of directors, who, under the applicable Colorado privilege statute, were given expressly the power to waive the corporation's accountant-client privilege. *Weck* was founded centrally upon the view that the bankruptcy trustee takes the place and exercises the office of the corporate directors.[150] The rationale employed in *Gorman* emphasized that the purpose of the trustee's questions was to assert a right on behalf of the estate and that a contrary holding would "hamper and hinder" the trustee.[151]

## VI. DISCHARGE

### A. *Debts*

#### 1. FRAUD

Two of the more fertile sources of litigation under the Act are whether a debt is nondischargeable because it was obtained through fraud and whether a general discharge of the bankrupt or debtor should be allowed when the bankrupt has violated the law, engaged in fraud, or destroyed essential books and documents. The first question arises under section 17a of the Act. The second question arises under section 14 of the Act.

---

146. *Id.* at 5, *quoting* § 70a(3) of the Act.

147. *Id.*, *citing* 4A COLLIER ON BANKRUPTCY, *supra* note 28, ¶ 7.13(2), at 124.

148. No. 75-265-T, slip op. at 5 (M.D. Fla. Oct. 12, 1976).

149. 161 Colo. 384, 422 P.2d 46 (1967). The *Gorman* court also cited *In re Fuller*, 262 U.S. 91 (1923) which the bankruptcy court characterized as holding that: "A recognition of the [fifth amendment] privilege would have obstructed and frustrated the bankruptcy trustee to acquire 'properties' of the estate." No. 75-265-T, slip op. at 6 (M.D. Fla. Oct. 12, 1976).

150. 161 Colo. at 388, 422 P.2d at 48.

151. No. 75-265-T, slip op. at 6 (M.D. Fla. Oct. 12, 1976).

Generally, section 17 exempts from discharge any provable debt of the bankrupt which was created or obtained by fraud. The statutory provisions encompass obtaining money or property by false pretenses, and obtaining extensions of credit through materially false, written financial statements.[152] Since a discharge of the debt can be avoided under such circumstances, section 17 is invoked frequently by the creditor since he has nothing to lose and everything to gain by doing so.

Three critical stumbling blocks exist for the creditor seeking to avoid the discharge of an indebtedness under section 17: failures to show reliance, materiality, and intent to deceive. Even a materially false financial statement is insufficient. There must be an intention to deceive or such a reckless disregard for the truth as to be tantamount to willful misrepresentation.[153] Imputed or implied fraud will not do; the party alleging fraud must prove actual or positive fraud.[154] The creditor must show by clear and convincing evidence that: (1) the debtor made a false representation; (2) he knew it was false at the time; (3) he made it with the intention and purpose of deceiving the creditor; (4) the creditor relied on the representation; and (5) the creditor sustained loss and damages as a proximate result of the misrepresentation.[155]

The bulk of the litigation under section 17 involves alleged fraud in connection with obtaining money or property on credit. In a number of recent decisions, some courts have abandoned the requirement of an affirmative misrepresentation as a precondition to

---

152. Bankruptcy Act § 17a. This section provides in pertinent part:

> (a) A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as . . . are liabilities for obtaining money or property by false pretenses or false representations, or obtaining money or property on credit or obtaining an extension or renewal of credit in reliance upon a materially false statement in writing respecting his financial condition made or published . . . in any manner whatsoever with intent to deceive, or for willful and malicious conversion of the property of another . . . .

153. *In re* Starr Parker, No. 75-870 (M.D. Fla. July 19, 1976); United States v. Syros, 254 F. Supp. 195 (E.D. Mo. 1966).

154. As the court pointed out in *Avco Fin. Servs. v. Jackson*, No. 75-592 (M.D. Fla. Apr. 8, 1976), what must be shown is "proof of cunning, deceit, or artifice employed to circumvent, to cheat, or to deceive another." Public Fin. Corp. v. Taylor, 514 F.2d 1370 (9th Cir. 1975); CIT Fin. Servs., Inc. v. Gabriel, 2 Bankr. Ct. Dec. 128 (W.D. Mo. Jan. 13, 1976); *In re* Dolnick, 374 F. Supp. 84 (N.D. Ill. 1974).

155. Beneficial Fin. Co. v. Johnston, No. 75-970 (S.D. Fla. Mar. 25, 1976); Public Fin. Corp. v. Taylor, 514 F.2d 1370 (9th Cir. 1975); Friendly Fin. Serv. Co. v. Windham, 240 So.2d 26 (La. App. 1970).

establishing nondischargeability under section 17a(2).

In *Montgomery Ward Co. v. Beaser*,[156] the district court anticipated the Fifth Circuit's rejection of its rule which requires an *overt* false pretense or misrepresentation in order to render a debt nondischargeable under section 17a(2) of the Act. That section exempts from a discharge in bankruptcy liabilities "for obtaining money or property by false pretenses or false representations."[157] In *Beaser*, a creditor attempted to block the discharge of a debt arising out of a bankrupt's revolving charge account. Beaser had submitted a credit application which overstated his income. He made numerous purchases under the charge plan at times when he could not have believed reasonably that he could pay for them. The question was whether the debts thus created were within the rule established by the Fifth Circuit in *Davison-Paxon Co. v. Caldwell*.[158] The *Caldwell* decision did not appear to include within section 17a(2) subsequent purchases which were made without any *overt* misrepresentation: "The only kind of fraud which will prevent a discharge is that committed by fraudulent misreprsentations of fact or by such conduct or artifice having a fraudulent purpose as will throw one off his guard and will cause him to omit inquiry or examination which he would otherwise make."[159]

Caldwell's restrictive language was characterized by the *Beaser* court as "not bear[ing] close scrutiny."[160] Rejecting the *Caldwell* rule, the court followed the line of authority, exemplified by *In re Black*,[161] which held that every credit purchase contains an implied promise to pay for the merchandise. Under this view, a credit purchase made with actual knowledge that sufficient funds to pay for the purchase will never exist results in "symbolic misrepresentations,"[162] satisfying section 17a(2).

Section 17a(2) contains no express requirement of an *overt* false pretense or misrepresentation. It appears that the *Caldwell* rule was created more by judicial fiat than by statutory compulsion. Indeed, a strong dissent in *Caldwell* advanced the rule adopted in *Beaser*.[163]

156. No. 75-716 (M.D. Fla. Mar. 22, 1976).
157. Bankruptcy Act § 17a(2).
158. 115 F.2d 189 (5th Cir. 1940), *cert. denied*, 313 U.S. 564 (1941).
159. *Id.* at 191-92.
160. No. 75-716, slip op. at 3 (M.D. Fla. Mar. 22, 1976).
161. 373 F. Supp. 105 (E.D. Wis. 1974).
162. *Id.* at 107.
163. 115 F.2d at 192 (Sibley, J., dissenting).

*Beaser* was the first open rejection of *Caldwell* in the Fifth Circuit. Although not known to the district court at the time, the Fifth Circuit's apparent dissatisfaction with *Caldwell* had been evidenced in *Sears, Roebuck & Co. v. Boydston,*[164] where it was acknowledged openly in dicta that *Caldwell* "has been severely eroded in the modern world of credit transactions and the decision has been the subject of much criticism."[165]

It appears that the Fifth Circuit will reject *Caldwell.* Credit purchases made with knowledge that they cannot be paid for should be considered nondischargeable. The present erosion and probable future abandonment of *Caldwell* may have substantial import in personal bankruptcies since many credit card transactions are often a major part of the debts owed.

In *Bank of Clearwater v. Sullivan,*[166] the court faced a contested dischargeability issue involving a Master Charge card. The debtor, who had a Master Charge card with a $500 credit limit, stated on his card application that he had an income of $700 monthly. He had virtually no income. During a two-week period, he made nearly $3,000 worth of credit purchases with his card.

Even though the debtor obviously lied on his credit application, the court rejected the bank's reliance upon the second sentence of section 17a(2) which bars the discharge of liabilities founded upon money or property obtained on credit by virtue of a materially false, written statement. The court did so because the credit card application did not call for a disclosure of *all* the assets and liabilities of the applicant. As a result, it was not a "financial statement" according to the court.

However, the court upheld the bank's claim for a bar to discharge under the first sentence of section 17a(2), for obtaining money or property under false pretenses. In accordance with the Fifth Circuit's remarks in *Boydston,* the court held that in making credit card purchases beyond his ability to pay, the debtor had represented symbolically that he had the means and intention to pay for them.

Initially it appears that the court's approach virtually eliminates from the Act the fraud-in-connection-with-credit provision of

164. 520 F.2d 1098 (5th Cir. 1975).
165. *Id.* at 1101.
166. No. 75-632 (M.D. Fla. Nov. 23, 1976).

section 17a(2). It allows the creditor to bar a discharge under the general obtaining-money-by-false pretenses standard, while the circumstances of the debt more specifically involve a credit transaction. This situation seems to be covered more appropriately by the fraud-in-connection-with-credit provision which, according to the court, was not satisfied. However, no injury is done to the statutory scheme or the legislative intent by such a reading. The fraud-in-connection-with-credit provision of section 17a(2) was added by the 1962 amendments to the Act. Previously, the courts had begun to hold that obtaining money or property on credit through false pretenses was within the existing language of section 17a(2).[167] The section 17 amendment was inserted apparently in connection with the amendment of section 14c(3), in order to protect the particular creditor who was defrauded by financial statements through which credit was obtained, while limiting the right of other creditors to prevent a discharge entirely.

It has become the practice of many small loan companies to include "boilerplate" statements in their credit applications to enhance their ability to bar a discharge under section 17. This practice is due to the strict construction courts have placed on section 17a(2) by requiring that a "financial statement" request the disclosure of all liabilities,[168] that the creditor prove an actual intent to defraud rising almost to criminal intent,[169] and that the creditor clearly prove reliance.[170] However, the use of these statements has met with varying results.

In *General Finance Corp. v. Studstill*,[171] the debtor completed a loan application bearing a printed legend stating that by extending credit, the lender was relying upon the financial statement, that a false statement could result in the loss of the dischargeability of a debt in bankruptcy, and that no one had suggested that the debtor could omit any of the debts.[172] In completing the credit application,

---

167. *See, e.g., In re* Freudman, 130 F. Supp. 701 (S.D.N.Y. 1954), *aff'd*, 222 F.2d 369 (2d Cir. 1955); 1A COLLIER ON BANKRUPTCY, *supra* note 28, ¶ 17.16[3], at 1641-42.

168. Dial Fin. Co. v. Duthu, 188 So. 2d 151 (La. App. 1966).

169. Public Fin. Corp. v. Taylor, 514 F.2d 1370 (9th Cir. 1975); Liberty Loan Corp. v. Broome, No. 75-545 (M.D. Fla. Apr. 19, 1976).

170. Public Fin. Corp. v. Taylor, 514 F.2d 1370 (9th Cir. 1975); CIT Fin'l Servs., Inc. v. Gabriel, 2 Bankr. Ct. Dec. 128 (W.D. Mo. 1976).

171. No. 75-220 (M.D. Fla. July 27, 1976).

172. The printed legend read in full:

Notwithstanding any previous dealing I may have had with General Finance, I the debtors stated that they had no outstanding obligations to retail stores, although they did. Without discussion, the court held that the debt was nondischargeable. Taking into consideration the number of creditors and the amount of debts omitted from the statement, the court found that it was reasonable to infer that the statement was submitted to induce the plaintiff to grant the loan with specific intent to deceive the lender. The court further concluded that the lender relied on those statements.

In *Beneficial Finance Co. v. Johnston*,[173] however, the United States District Court for the Southern District of Florida upheld the dischargeability of a debt made in connection with a credit statement which contained a statement similar to that involved in *Studstill*.[174] Although the credit statement contained an acknowledgement by the debtor that he had not been instructed to omit any of his debts, the evidence revealed that he actually had been so instructed by an agent of the lender.

The court's general attitude toward such attempts to bar discharge under section 17a(2) was reflected most clearly in *CIT Financial Services, Inc. v. Gabriel*.[175] In *CIT* the court denied a small loan company's attempt to bar discharge under a highly detailed document containing typical "boilerplate" language. The court observed that absent clear and undisputed evidence of all the elements of fraud, the debtor usually wins, frequently by a failure to find deceitful intent. In upholding the dischargeability of the debt in *CIT*, the

---

> understand that in extending credit to me, it is relying on my Financial Condition as shown in this Statement made by me. I understand that giving a false statement of my financial condition may result in civil liabilities and a possible loss of right to have a debt discharged in Bankruptcy. I have read the instructions before I completed this Statement. NO ONE HAS SUGGESTED THAT I MAY OMIT ANY OF MY DEBTS.

*Id.* at 2 (emphasis in original).

173. No. 75-970 (S.D. Fla. Mar. 25, 1976).

174. The Beneficial Finance Statement provided the following warning: "Notice: If you knowingly give a false statement regarding your credit, and the lender relies on it in part in making the loan, your obligation would not be dischargeable in bankruptcy. For your benefit this credit statement should be true and complete." The following appeared on the credit statement just above the signature of the defendant:

> I have no debts and liabilities in excess of $25.00 other than those listed hereon. I certify that I have not been instructed by the Lender to which I have made an application for a loan to list only certain debts. Instead my instructions have been to list all outstanding debts and liabilities.

*Id.* at 2.

175. 2 Bankr. Ct. Dec. 128 (W.D. Mo. 1976).

court emphasized the disparity in financial sophistication between the typical small loan company and its client. Most importantly, the court pointed out that under such unequal circumstances, loan managers "have the positive obligation to prove that the bankrupts were thoroughly informed on the 'facts of life' . . . prior to the filling out of the so-called financial statement if they are to prove an intent to deceive on the part of a borrowing bankrupt."[176]

In any event, the bankrupt or debtor must obtain "money or property" before section 17 can apply. Normally, a finding that money or property was obtained is obvious. In *Williams v. Harris*,[177] such was not the case. The question was one of first impression: Whether the obtaining of a loan guaranty constitutes the obtaining of "money or property" within the meaning of section 17a(2). The bankrupt induced the objecting creditor to "co-sign" with him a note which was given to obtain a loan. The loan proceeds were used by the bankrupt's corporation. The cosignee subsequently had to pay the note when the bankrupt defaulted. Although the cosignature was obtained through false statements, the loan was not. The bankrupt argued that the cosignature was not "money or property" within the meaning of section of 17a(2), so that his debt to the cosignee could be discharged.

The court avoided the question of whether a cosignature is "money or property," by holding that the "money or property" requirement of section 17a(2) was satisfied by the loan made to the bankrupt. Faced with scant and conflicting authority,[178] the court held essentially that section 17a(2) does not require that the fraud or false pretenses be practiced upon the initial lender, but only that the "money or property" be obtained in connection with false pretenses upon *someone* without whom the loan would not have been made. In that sense, money from the lender was obtained clearly as a result of the false pretenses practiced upon a guarantor without whom the loan would not have been made. In addition, the court pointed out that the Act does not require that the "money or property" pass directly to the bankrupt, as long as the creditor parts with the money "on behalf of" the bankrupt.[179]

---

176. *Id.* at 132.

177. No. 75-1245-T (M.D. Fla. Aug. 10, 1976).

178. Gleason v. Thaw, 236 U.S. 558 (1915); Barnes v. Frost, 160 Miss. 131, 133 So. 11 (1931); Garr v. Martin, 20 N.Y. 306 (1859).

179. Williams v. Harris, No. 75-1245 (M.D. Fla. Aug. 10, 1976), *citing In re* Dunfee, 94

### 2. ALIMONY

In *Maiman v. Maiman*,[180] the court held dischargeable a debt owed to a divorced wife by her prior husband under a hold harmless clause contained in a stipulation in a final judgment of dissolution of marriage. Section 17a(7) of the Act exempts from discharge debts for alimony due or to become due, or for maintenance or support of a wife or child.

In the dissolution judgment, obtained in New York, the husband and wife entered into a stipulation in which the wife waived any request for alimony, ostensibly because she was employed and doing well. It was stipulated also that the husband would hold the wife harmless for debts incurred during coverture. When the husband filed the bankruptcy petition, the wife sought to have the debt owed to her under the hold harmless provision deemed nondischargeable. It was the wife's position that the hold harmless clause was intended as a substitute for an award of alimony or maintenance and was therefore nondischargeable.

The court rejected the wife's argument on the simple ground that the stipulation in the dissolution proceeding nowhere evidenced either an intention to treat the hold harmless provision as a substitute for alimony, or that the wife's waiver of alimony was conditioned specifically upon performance of the hold harmless provision. In addition, there was no proof in the record before the New York court that the wife would have been entitled to alimony.

The *Maiman* decision is not strongly supported by prior authority. The decision's only citation of authority for the principle that the hold harmless debt would not be alimony under Florida law, *Belcher v. Belcher*,[181] does not clearly support the principle. In *Belcher*, the wife executed an antenuptial agreement waiving her right to alimony in the event of divorce. In return, she obtained from her husband assets worth more than $200,000. None of the several decisions arising out of the Belcher dissolution made any mention of a hold harmless provision in favor of the wife.[182]

---

Misc. Rep. 628, 159 N.Y.S. 703 (Sup. Ct. 1944).

180. 9 C.B.C. 118 (S.D. Fla. 1976).

181. 307 So. 2d 918 (Fla. 3d Dist. 1975).

182. *See* Belcher v. Belcher, 271 So.2d 7 (Fla. 1972); Belcher v. Belcher, 307 So. 2d 918 (Fla. 3d Dist. 1975); Belcher v. Belcher, 290 So. 2d 126 (Fla. 3d Dist. 1974); Belcher v. Belcher, 256 So. 2d 75 (Fla. 3d Dist. 1971).

Other jurisdictions have differed on this point. In *Waller v. Waller*[183] the dischargeability of a hold harmless provision which was executed as part of a separation agreement in Ohio was at issue.[184] The parties were later divorced. The husband filed in bankruptcy, and scheduled a debt owed to a furniture company. He did not list his ex-wife as a creditor. She filed no claim, and she did not know of the bankruptcy. After discharge of the bankrupt, the furniture company sued the ex-wife to recover the balance of the debt. The bankruptcy proceeding was reopened. The bankrupt contended that the hold harmless agreement was dischargeable because it constituted a property division, rather than alimony or support. Relying upon Ohio law,[185] the court held that hold harmless or indemnity provisions can constitute alimony. In so holding, the court emphasized the lack of any Ohio decision to the contrary, and that the purpose of the separation agreement and the indemnification provisions was to assure the wife of having furniture that would not be taken away by creditors of the husband.

A number of courts have faced the problem of characterizing, for bankruptcy purposes, provisions for the payment of money made in written agreements or by order of courts as either alimony or property settlement agreements.[186] Perhaps the best summary of the essential test is found in *In re Alcorn*,[187] where the court observed that:

> [T]he Court must look to the nature of the contract itself and ascertain whether the agreement is one which merely provides for the division of property between the parties, and as such is in lieu of alimony and a bona fide property settlement agreement, or whether the contract, although denominated 'property settlement agreement,' is one which embodies within its terms the

183. 494 F.2d 447 (6th Cir. 1974).

184. The separation agreement provided in pertinent part, under the heading "Prior Debts" that "[t]he husband shall pay and indemnify and hold the wife absolutely harmless from all existing obligations." *Id.* at 448.

185. Collins v. Smith, 26 Ohio Misc. 231, 270 N.E.2d 377 (Ohio C.P. 1971); Fredericks v. Fredericks, 76 Ohio Law Abst. 296, 146 N.E.2d 153 (Ct. App. 1956).

186. *See, e.g.*, *In re* Gorski, 25 F. Supp. 551 (W.D.N.Y. 1938) (nondischargeable); Roberts v. Roberts, 261 Cal.2d 424, 68 Cal. Rptr. 59 (Ct. App. 1968) (nondischargeable); Kadel v. Kadel, 250 N.E.2d 420 (Ohio C.P. 1969) (nondischargeable); Treece v. Treece, 458 P.2d 633 (Okla. 1969) (nondischargeable); Lyon v. Lyon, 115 Utah 466, 206 P.2d 148 (1949) (dischargeable).

187. 162 F. Supp. 206 (N.D. Cal. 1958).

> common law or statutory duty [of a husband to care for and support his wife] and, consequently, is essentially a contract for maintenance and support.[188]

Payments in the nature of support of the wife and child are also nondischargeable under section 17.[189] The *Maiman* decision may be subject to criticism because it did not engage clearly in any such analysis. It should, however, serve as a caution to drafters of hold harmless agreements in dissolution proceedings, particularly when bankruptcy of the covenantor is foreseeable. If the agreement is in the nature of alimony or support, it should at least so state.

### B. *Debtors*

Under section 14c of the Act, a full discharge may be denied if the bankrupt has destroyed, falsified, or failed to preserve adequate records of his financial condition, or if he fails to explain losses of assets.[190] In *Appelberg v. Harrison*,[191] the court denied the bankrupt a discharge when the bankrupt was unable to explain the disappearance of $30,000 during the month preceding the filing of his petition in bankruptcy. The bankrupt's explanation was that most of the money was spent on clothes and food, but he could produce no proof of purchase. Invoking the rule that only honest debtors are to receive a discharge, the court held that sections 14c(2) and (7) of the Act were violated, even though the expenses were not of the type for which a duty to keep records is normally recognized. The court held that even though the bankrupt's activities were supposedly social, they were sufficiently *extensive* to require that some records be kept to prove them in bankruptcy.

---

188. *Id.* at 209. For an excellent, recent discussion of these principles, see Abrams v. Burg, 327 N.E.2d 745 (Mass. 1975).

189. *In re* Hollister, 47 F. Supp. 154 (S.D.N.Y. 1942).

190. Section 14c of the Act provides in pertinent part:

> The court shall grant the discharge unless satisfied that the bankrupt has . . . (2) destroyed, mutilated, falsified, concealed, or failed to keep or preserve books of account . . . from which his financial condition . . . might be ascertained . . . or (7) has failed to explain satisfactorily any losses of assets or deficiency of assets to meet his liabilities . . . [If] upon the hearing of an objection to a discharge, the objector shall show to the satisfaction of the court that there are reasonable grounds for believing that the bankrupt has committed any of [these acts,] . . . then the burden of proving that he has not committed any of such acts shall be upon the bankrupt.

191. No. 75-567 (M.D. Fla. July 27, 1976).

The duty to keep records under section 14c(2) always has been applied practically to the particular circumstances of each case. Generally, the rule has been that unless the bankrupt's situation "was such that the normal person under like circumstances would not have kept books and records," he is not required to do so.[192] The courts have emphasized that section 14c provides expressly that a failure to keep books or records which is "justified under all the circumstances of the case"[193] is sufficient to avoid a denial of discharge. Thus, it has been held in several instances of nonbusiness expenses that no duty to keep books arises. However, these decisions typically have involved salaried employees or situations where it would otherwise be ludicrous to expect records to be kept.[194]

The Fifth Circuit has required a hearing upon whether the bankrupt's business "was of sufficient complexity to require the keeping of books and records."[195] Both the Fifth Circuit and the Fourth Circuit have held that large sums of money squandered or gambled away without adequate records can result in a denial of discharge, regardless of the condition of the *business* books.[196] It should also be noted that Bankruptcy Rule 407 has superseded and changed the burden of proof allocated by section 14c in disputed discharge proceedings. The rule provides that "the plaintiff has the burden of proving the facts essential to his objection."[197] This is contrary to section 14c, which provides that once the objector has shown reasonable grounds for believing that the bankrupt has committed a prohibited act, "the burden of proving that he has not committed any such acts shall be upon the bankrupt."[198]

The court in *Appelberg* also considered the objector's claim that section 14c(7) prevented discharge, on the ground that the

192. *In re* Weismann, 1 F. Supp. 723 (S.D.N.Y. 1932).

193. Bankruptcy Act § 14c(2).

194. *See, e.g.*, Morris Plan Indus. Bank v. Dreaher, 144 F.2d 60 (2d Cir. 1944) (itinerant rags and clothes peddler); *In re* Worlay, 47 F. Supp. 212 (D. Neb. 1942); *In re* Rios, 27 F. Supp. 744 (S.D.N.Y. 1939).

195. Bartolotta v. Lutz, 485 F.2d 227, 228 (5th Cir. 1973).

196. McBee v. Sliman, 512 F.2d 504 (5th Cir. 1975); Crider v. Jordan, 255 F.2d 378 (4th Cir. 1958).

197. Bankruptcy Rule 407. In *In re* Tucker, 399 F. Supp. 660, 661 (S.D. Fla. 1975) the court stated: "Rule 407 removed the 'burden shifting' provision of § 14(c) of the Bankruptcy Act. . . . and placed it at all times upon the objecting creditor."

198. Bankruptcy Act § 14c. *See* Feldenstein v. Radio Distrib. Co., 323 F.2d 892 (6th Cir. 1963); Johnson v. Bockman, 282 F.2d 544 (10th Cir. 1960); *In re* Pioch, 235 F.2d 903 (3d Cir. 1956).

bankrupt had failed to explain satisfactorily his loss of assets. The court held such explanations as "I paid debts" to be insufficient.[199]

## VII. PREFERENCES

In *Koscot Interplanetary, Inc. v. Turner Enterprises, Inc.*,[200] the court rejected a novel preference theory. The problem arose because the Internal Revenue Service filed a large claim which thwarted an arrangement proceeding. Being unable to pay the tax claim, the debtor sought to reduce or eliminate it. The debtor asked the court to set aside a net operating loss deduction that it had "transferred" to its subsidiary by filing a consolidated federal income tax return. According to the debtor, a net operating loss was "property" which was "transferred" without consideration, thus rendering it fraudulent as to existing creditors under the Bankruptcy Act.[201]

The court first suggested that a net operating loss available under the tax law could constitute "property" under the Act. The court observed in particular that section 70a of the Act provides a comprehensive general test for determining whether the property in question is part of the estate. According to the test, the trustee holds title to all "property," including rights of action, which the bankrupt could have transferred and which might have been levied upon and sold. Tax refund claims have been held to be property under the Act.[202] Whether something is "property" under the Act is determined in view of the twofold purpose of the Act: (1) to convert the estate into cash for distribution among the creditors; and (2) to give the bankrupt a "fresh start."[203] It has been said that:

199. Appelburg v. Harrison, No. 75-567 (M.D. Fla. July 19, 1976), *citing* Minella v. Phillips, 245 F.2d 687 (5th Cir. 1957). Section 14c(7) has not been "fully explored." The best that has been said is probably that a "satisfactory explanation" or a loss of assets "probably means that the bankrupt must explain his losses or deficiencies in such manner as to convince the court of good faith and business-like conduct," not that he adequately explained his losses, regardless of how they came about. 1A COLLIER ON BANKRUPTCY, *supra* note 28, ¶ 14.60, at 1436.

200. No. 73-179 (M.D. Fla. May 10, 1976).

201. Bankruptcy Act § 67d(2). This section provides:

> Every transfer made and every obligation incurred by a debtor within one year prior to the filing of a petition initiating a proceeding under this Act by or against him is fraudulent (a) as to creditors existing at the time such transfer or obligation, if made or incurred without fair consideration by a debtor who is or will be thereby rendered insolvent, without regard to his actual intent.

202. *See* Kokoszka v. Belford, 417 U.S. 642 (1974), *aff'g In re* Kokoszka, 479 F.2d 990 (2d Cir. 1973); Segal v. Rochelle, 382 U.S. 375 (1966).

203. Kokoszka v. Belford, 417 U.S. 642, 646 (1974), *citing* Segal v. Rochelle, 382 U.S.

> The main thrust of Section 70a(5) is to secure for creditors everything of value the bankrupt may possess in alienable or leviable form when he files his petition. To this end the term "property" has been construed most generally and an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed.[204]

Net operating loss deductions are not leviable. In addition, they are not freely assignable among the general public, being available for "transfer" only in very limited situations among related corporate entities. As a result, they do not satisfy easily the test for "property." The fact that tax refunds have been held to be "property" under the Act is unpersuasive, since refunds represent a claim for *cash* against the treasury. *Koscot* did not make clear whether a "setting aside" of the transfer of the net operating loss would result in an actual refund due the debtor, or would result only in a reduction in taxes due.[205] The mere right to a tax *reduction* not resulting in a refund does not ever before appear to have been recognized as "property" under the Act. Nevertheless, it seems logical that since even a reduction in the debtor's tax liability would inure to the direct benefit of the estate and the creditors, it falls within the spirit of section 70 and the Act.[206]

The court in *Koscot* found plausible all other premises for setting aside the "transfer" of the net operating loss deduction. However, the court held that it was without power to grant the relief requested by the debtor since such relief would be the granting of

375 (1966); Short v. Grand, 507 F.2d 425, 427 (8th Cir. 1974), *citing* Kokoszka v. Belford, 417 U.S. 642 (1974).

204. Kokoszka v. Belford, 417 U.S. 642, 646 (1974), *quoting* Segal v. Rochelle, 382 U.S. 375, 379 (1966).

205. The court's only observation as to the possible effect of allowing the deconsolidation sought by the debtor was that: "The election to file the consolidated return deprived Koscot of something which otherwise would have been available to it and could have conceivably either have reduced or extinguished its tax liability." No. 73-179, slip op. at 7 (M.D. Fla. May 10, 1976).

206. The court observed that the "transfer" did not offend the Assignment of Claims Act, 31 U.S.C. § 203 (1970), even though strict compliance with the Assignment Act was not rendered. The Assignment Act, literally read, renders null the transfer or assignment of "any claim upon the United States," unless certain formalities are complied with and occur after allowances of the claim by the government. However, the law has been construed to allow enforcement of an otherwise invalid transfer between the assignee and assignor when no danger exists that the government will be exposed to multiple claims thereon. *See* Segal v. Rochelle, 382 U.S. 375, 384-85 (1966); Martin v. National Sur. Co., 300 U.S. 588, 594-95 (1937); *In re* Lagerstrom, 300 F. Supp. 538 (S.D. Ill. 1969).

leave to file an amended or "deconsolidated" tax return for the relevant tax years. Since the method of filing tax returns is governed by the Internal Revenue Code, not the Bankruptcy Act, the relief sought could be granted only if it were consistent with the Internal Revenue Code. Citing authority to the effect that the election to file a consolidated return is binding and cannot be revoked to effect a tax saving,[207] the court held that it was without power to grant the relief requested by the debtor.

In *Mullen v. Liberty Mutual Insurance Co.*,[208] the court rejected the argument that a judgment lien founded upon a nondischargeable debt is not subject to the preference provisions of section 67a of the Act.[209] The trustee sought to invalidate a judgment lien obtained by a title insurance company against the bankrupt. The bankrupt was insolvent when the judgment was obtained, and the judgment was obtained within four months of the initiation of bankruptcy proceedings.

The trustee sued to have the judgment lien declared null and void as a preference under section 67a. The judgment lienor argued that, while judgment lien preferences were normally avoidable by the trustee, when the lien was founded upon a nondischargeable debt, the preference provisions did not apply. The judgment lienor argued further that the debt supporting the judgment was founded upon fraud and would be nondischargeable under sections 17a(2) and (4) of the Act.[210]

Without citation of authority, the court held that section 67a does not have any limitation based upon the dischargeability of the debt upon which the judgment lien was obtained. The court emphasized that section 17 does not state that judgment liens based on

207. *See* Manchester Sav. Bank & Trust Co. v. Commissioner, 34 B.T.A. 1008 (1936).

208. 9 C.B.C. 45 (S.D. Fla. 1976).

209. Section 67a provides in pertinent part:

*Liens and Fraudulent Transfers*

(1) Every lien against the property of a person obtained by . . . judgment . . . within four months before the filing of a petition initiating a proceeding under this Act by or against such person shall be deemed null and void (a) if at the time, when such lien was obtained such person was insolvent . . . .

210. Section 17a of the Act provides:

*Debts Not Affected by a Discharge*

A discharge in bankruptcy shall release a bankrupt from all of his provable debts . . . except such as . . . (2) are liabilities for obtaining money or property by false pretenses or false representations . . . (4) were created by his fraud . . . while acting as an officer or in any fiduciary capacity . . . .

such debts are not affected by section 67a. The court distinguished between section 17, which refers to debts, and section 67a, which refers to liens.

The court's rejection of the lienor's argument seems eminently correct. Section 67a serves the sole purpose of allowing the bankruptcy trustee to avoid the effect of a judgment lien upon the estate. It invalidates only the lien, not the obligation or debt upon which the lien is founded.[211] The section also only operates to invalidate liens that are created by a judgment. It does not operate where the judgment is obtained to enforce a preexisting statutory or common law lien.[212]

Thus, the judgment lienor whose lien is avoided by the trustee still can file a proof of claim and share in distribution to the extent provided in the plan. If not barred by discharge, the judgment lienor can enforce his judgment under the appropriate state law after bankruptcy.

Although decisions are few, and none were cited by the *Mullen* court, the courts which have faced the question have reached a similar result.[213] However, an early Fifth Circuit decision contained an indication to the contrary.[214]

---

211. *In re* Wesley Corp., 18 F. Supp. 347 (E.D. Ky. 1937).

212. Ricotta v. Burns Coal & Bldg. Supply Co., 264 F.2d 749 (2d Cir. 1959); New York Brooklyn Fuel Corp. v. Fuller, 11 F.2d 802 (2d Cir. 1926); *In re* Chesterfield Dev., Inc., 285 F. Supp. 689 (S.D.N.Y. 1968); *In re* Van Meter, 135 F. Supp. 781 (W.D. Ark. 1956); *In re* Wesley Corp., 18 F. Supp. 347 (E.D. Ky. 1937).

213. Wagler v. Mt. Carmel Iron Works, 270 F. 80 (3d Cir. 1921); Bear v. Chase, 99 F. 920, 921 (4th Cir. 1900); *In re* Green, 179 F. 870 (W.D. Pa. 1910).

214. Westmoreland v. Dodd, 2 F.2d 212 (5th Cir.), *cert. denied*, 267 U.S. 595 (1924).